

***United States Court of Appeals
for the Second Circuit***



APPELLEE'S BRIEF

77-6034,

77-6038, 77-6040, 77-6044, 77-6045, 77-6048, 77-6065

United States Court of Appeals

FOR THE SECOND CIRCUIT

In the Matter of
WEIS SECURITIES, INC.,

Debtor.

GEORGE D. ALDRICH, et al.,

Appellants,

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

JOINT BRIEF FOR APPELLEES

HUGHES HUBBARD & REED
One Wall Street
New York, New York 10005

*Attorneys for Edward S. Redington,
Trustee*

and

THEODORE H. FOCHT
General Counsel
900 Seventeenth Street, N.W.
Suite 800
Washington, D.C. 20006

*Attorney for Securities Investor
Protection Corporation*

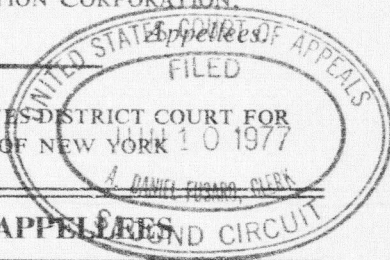


TABLE OF CONTENTS

	Page
Table of Authorities	iv
Preliminary Statement	1
COUNTER-STATEMENT OF QUESTIONS PRESENTED FOR REVIEW	3
STATUTES AND RULES INVOLVED	3
COUNTER-STATEMENT OF THE CASE	4
<i>What Is At Stake</i>	4
<i>The Motion For Summary Judgment</i>	5
<i>The Subordination Agreements</i>	6
<i>The Role of Subordination Agreements Under Financial Responsibility Rules</i>	7
<i>Motivation for Subordination Agreements</i>	9
<i>Opinion of the Bankruptcy Judge</i>	10
<i>The District Court Opinion</i>	10
SUMMARY OF ARGUMENT	11
ARGUMENT	12
I. CLAIMANTS CANNOT AS A MATTER OF LAW REPU- DIATE PROMISES MADE TO PERMIT WEIS TO COMPLY WITH REGULATORY REQUIREMENTS AND CONTINUE DEALING WITH THE PUBLIC	12
A. Reliance By Individual Creditors Need Not Be Shown In Regulated Industries Where The Promises Sought To Be Repudiated Were A <i>Sine</i> <i>Qua Non</i> for The Debtor's Dealing With The Public	12

	Page
B. Claimants' Promises to Subordinate Were a <i>Sine Qua Non</i> for Weis's Dealing With the Public	19
1. <i>The Debtor Was Subject to "Net Capital" Rules Pursuant to Which It Obtained Large Amounts of Subordinated Capital for the Protection of Everyone With Whom It Would Do Business</i>	19
2. <i>Because of the Lenders' Promises, the Amounts Subject to Subordination Agreements Could Be Counted as Part of Its Net Capital</i>	22
C. The District Court Correctly Applied and Interpreted the <i>CIC</i> Case	23
D. The Other Cases Cited by the Lenders Do Not Support Rescission of Subordination Agreements Subject to the Net Capital Rule	24
1. <i>Cases Not Involving Obligations Intended To Ensure Financial Stability in Regulated Industries Cannot Support a Right of Rescission in This Case</i>	24
2. <i>Reorganization or Other Non-Bankruptcy Cases Cannot Support a Right of Rescission in This Case</i>	25
3. <i>The Aixala Case Does Not Support a Right of Rescission in This Case</i>	28
E. The "Legislative Developments" Cited by The Lenders Do Not Support Rescission in This Case	29
F. The Securities Laws Do Not Support Rescission in This Case	31
G. SIPA Has Not Superseded the Net Capital Rules or Diminished the Importance of a "Cushion" of Subordinated Capital	34
II. THE LENDERS ARE BOUND BY THEIR PROMISES TO THE EXCHANGE, A SELF-REGULATORY AUTHORITY WHICH DID NOT PARTICIPATE IN ANY MISCONDUCT OF THE DEBTOR	36

	Page
III. APPELLANT GROSSMANN'S "SEPARATE AND ADDITIONAL" THEORIES FOR PREFERENTIAL TREATMENT ARE UNSOUND AND INCONSISTENT WITH THE FACTS	39
A. Mrs. Grossmann's Factual Ground for Rescission Is No Better Than Anyone Else's; She Understood She Was Making a Contribution of Capital to the Debtor	40
B. Mrs. Grossmann Was Never a Customer of Weis	41
C. There Is No Ground for Asserting a "Constructive Trust" and Nothing to Which Such a "Constructive Trust" Could Attach	42
D. Mrs. Grossmann Can Claim No Rights Under the Illinois Bulk Sales Act	43
IV. THE TRUST CANNOT BE TREATED MORE FAVORABLY THAN OTHER SUBORDINATED LENDERS	44
A. Priorities Among Creditors Can Be Established Only by the Provisions of the Bankruptcy Act	45
B. The Trust Is Not Entitled to Priority Pursuant to Section 64 of the Bankruptcy Act	46
V. RELIANCE BY CUSTOMERS AND CREDITORS SHOULD AT LEAST BE PRESUMED TO EXIST AND ANY REQUIREMENT OF A SHOWING ON THAT ISSUE BY THE TRUSTEE SHOULD AWAIT PROOF OF FACTS ENTITLING LENDERS TO RESCIND	48
CONCLUSION	50
ADDENDUM OF STATUTORY PROVISIONS AND RULES	A-1

TABLE OF AUTHORITIES

CASES:

	Page
<i>Aixala v. W.E. Hutton & Co.</i> , [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94, 981 (S.D.N.Y. 1975)	28
<i>Anderson v. Cronkleton</i> , 32 F.2d 170 (8th Cir. 1929)	14
<i>Arneil v. Ramsey</i> , 550 F.2d 774 (2d Cir. 1977)	33
<i>Ashton v. Glaze</i> , 95 F.2d 427 (9th Cir. 1938)	18
<i>Ball v. Shepard</i> , 202 N.Y. 247, 95 N.E. 719 (1911)....	36
<i>Berry Harvester Co. v. Walter A. Wood Mowing & Reaping Mach. Co.</i> , 152 N.Y. 540, 46 N.E. 952 (1897)	36
<i>Best v. Thiel</i> , 79 N.Y. 15 (1879)	13, 14
<i>Blaise D'Antoni & Associates v. SEC</i> , 289 F.2d 276 (5th Cir.), cert. denied, 368 U.S. 899 (1961)	20
<i>Brooklyn Trust Co. v. Fairfield Gardens, Inc.</i> , 260 N.Y. 16, 182 N.E. 231 (1932)	13, 38
<i>B. V. Emery & Co. v. Wilkinson</i> , 72 F.2d 10 (10th Cir. 1934)	13
<i>Cawthon v. Bancokentucky Co.</i> , 52 F.2d 850 (W.D. Ky. 1931)	28, 30n.15
<i>Clark v. Boston-Continental Nat'l Bank</i> , 84 F.2d 605 (1st Cir. 1936)	25
<i>County Trust Co. v. Mara</i> , 242 App. Div. 206, 273 N.Y.S. 597 (1st Dep't 1934), aff'd, 266 N.Y. 540, 195 N.E. 190 (1935)	13n.7
<i>Davis v. Burns</i> , 173 S.W. 476 (Ct. App. Tex. 1918)....	14n.8
<i>Dale v. Rosenfeld</i> , 229 F.2d 855 (2d Cir. 1956)	32
<i>D'Oench, Duhme & Co. v. FDIC</i> , 315 U.S. 447 (1942)	13
<i>Deckert v. Independence Shares Corp.</i> , 311 U.S. 282 (1940)	32
<i>Exchange National Bank v. Touche Ross & Co.</i> , 544 F.2d 1126 (2d Cir. 1976)	31
<i>Florida Land & Imp. Co. v. Merrill</i> , 52 F. 77 (5th Cir. 1892)	25n.12

	Page
<i>Green v. Stone</i> , 205 Ala. 381, 87 So. 862 (1921)	14n.8
<i>Hughes v. Dempsey-Tegeler & Co.</i> , 534 F.2d 156 (9th Cir.), cert. denied, 97 S. Ct. 258 (1976)	20
<i>Hurd v. Kelly</i> , 78 N.Y. 588 (1879)	13, 14-15
<i>In re Cartridge Television, Inc.</i> , 535 F.2d 1388 (2d Cir. 1976)	16n.10, 27, 30
<i>In re Columbia Ribbon Co.</i> , 117 F.2d 999 (3d Cir. 1941)	45-46
<i>In re Credit Industrial Corp.</i> , 366 F.2d 402 (2d Cir. 1966)	13, 23, 48
<i>In re Delaware Hosiery Mills</i> , 202 F.2d 951 (3d Cir. 1953)	45
<i>In re Faber's, Inc.</i> , 360 F. Supp. 946 (D. Conn. 1973)	43
<i>In re F.O. Baroff Co.</i> , No. 76-5020 (2d Cir. May 12, 1977), slip op.	16n.10
<i>In re Four Seasons Nursing Centers of America, Inc.</i> , 472 F.2d 747 (10th Cir. 1973)	26
<i>In re Guy D. Marianette</i> , 11 S.E.C. 967 (1942)	21
<i>In re Los Angeles Land and Investments Ltd.</i> , 282 F. Supp. 448 (D. Hawaii 1968), aff'd per curiam, 447 F.2d 1366 (9th Cir. 1971)	26
<i>In re Morris Bros.</i> , 293 F. 294 (9th Cir. 1923)	30n.15
<i>In re National Association of Securities Dealers, Inc.</i> , 12 S.E.C. 322 (1942)	20
<i>In re Penn Central Transportation Co.</i> , 484 F.2d 1300 (3rd Cir. 1973), cert. denied, 415 U.S. 951 (1974)	46
<i>In re Recording Devices Co.</i> , 1 F.2d 474 (S.D. Ohio 1924)	30n.15
<i>In re Rhine</i> , 241 F. Supp. 86, rehearing denied, 242 F. Supp. 127 (D. Colo. 1965)	26n.13
<i>In re Weis Securities, Inc.</i> , 542 F.2d 840 (2d Cir. 1976)	16n.10
<i>Insurance Co. of North America v. Brehm</i> , 257 Ore. 385, 478 P.2d 387 (1971)	36
<i>Joint Industry Board v. United States</i> , 391 U.S. 224 (1968)	47

	Page
<i>Julian v. Stewart</i> , 56 F.2d 32 (5th Cir. 1932)	13, 17-18, 25n.12
<i>Junker v. Midterra Associates</i> , 49 F.R.D. 310 (S.D.N.Y. 1970)	32
<i>Lantry v. Wallace</i> , 182 U.S. 536 (1901)	13, 14
<i>Mills v. Electric Auto-Lite Co.</i> , 396 U.S. 375 (1975)....	32
<i>Mount Vernon Trust Co. v. Bergoff</i> , 272 N.Y. 192, 5 N.E.2d 196 (1936)	13
<i>Occidental Life Ins. Co. v. Pat Ryan & Assoc.</i> , 496 F.2d 1255 (4th Cir. 1974)	32
<i>Oppenheimer v. Harriman National Bank & Trust Co.</i> , 301 U.S. 206 (1937)	16, 25, 30, 41
<i>Pearlstein v. Scudder & German</i> , 429 F.2d 1136 (2d Cir. 1970)	32-33
<i>Peoples Trust Co. v. O'Neil</i> , 273 N.Y. 312, 7 N.E.2d 244 (1937)	36
<i>Pepper v. Litton</i> , 308 U.S. 295 (1939)	45
<i>Pond v. New Rochelle Water Co.</i> , 183 N.Y. 330, 76 N.E. 211 (1906)	37
<i>Porter v. Commissioner</i> , 60 F.2d 673 (2d Cir. 1932), <i>aff'd</i> , 288 U.S. 436 (1933)	13n.7
<i>Putnam Mills Corp. v. United States</i> , 432 F.2d 553 (2d Cir. 1970)	13n.7
<i>Royal Air Properties, Inc. v. Smith</i> , 312 F.2d 210 (9th Cir. 1952)	32
<i>Ryan v. Mt. Vernon Nat'l Bank</i> , 224 F. 429 (2d Cir. 1915)	14
<i>Salter v. Williams</i> , 244 F. 126 (3d Cir. 1917), <i>appeal dismissed</i> , 250 U.S. 653 (1919)	25
<i>Scott v. Deweese</i> , 181 U.S. 202 (1901)	13, 14, 15-16, 17, 25, 29
<i>SEC v. F. O. Baroff Co.</i> , 497 F.2d 280 (2d Cir. 1974)	41-42
<i>SEC v. G. L. Equities Corp.</i> , [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 63,624 (S.D.N.Y. 1972)....	21
<i>SEC v. S. J. Salmon & Co.</i> , 375 F.Supp. 867 (S.D.N.Y. 1974)	26n.13
<i>SEC v. Packer, Wilbur & Co.</i> , 498 F.2d 978 (2d Cir. 1974)	39, 46

	Page
<i>SEC v. Resch-Cassin & Co.</i> , 362 F. Supp. 964 (S.D.N.Y. 1973)	21
<i>SIPC v. Executive Securities Corp.</i> , Docket Nos. 77-6005, 77-6009 (2d Cir. May 20, 1977) Slip op.	41
<i>SIPC v. Barbour</i> , 421 U.S. 412 (1975)	34
<i>SIPC v. Morgan, Kennedy & Co.</i> , 533 F.2d 1314 (2d Cir. 1976)	35, 39, 46
<i>Spector v. National Cellulose Corp.</i> , 181 Misc. 465, 48 N.Y.S.2d 234 (Sup. Ct. N.Y. County 1943)	13, 37
<i>Standard Milling Co. v. Yoss</i> , N.Y.L.J., April 8, 1975, p. 2, col. 1, 16 U.C.C. Rep. Serv. 815 (Sup. Ct. New York County April 8, 1975)	44
<i>Straley v. Universal Uranium and Milling Corp.</i> , 289 F.2d 370 (9th Cir. 1961)	32, 33
<i>United States v. Embassy Restaurant, Inc.</i> , 359 U.S. 29 (1959)	47
<i>United States v. Killoren</i> , 119 F.2d 364 (8th Cir.), cert. denied, 314 U.S. 640 (1941)	45
<i>United States v. Randall</i> , 401 U.S. 513 (1971)	42
<i>Williams v. Green</i> , 23 F.2d 796 (4th Cir. 1918)	25

STATUTES, RULES & REGULATIONS:

<i>Bankruptcy Act</i> (11 U.S.C. §§ 1 <i>et seq.</i> (Sup. III 1973))	
11 U.S.C. § 93d	16n.10
11 U.S.C. § 103a	16n.10, 28
11 U.S.C. § 104a(2)	12, 44, 46
11 U.S.C. § 110(c)	37
Act of Dec. 23, 1913, c.6, § 23, 38 stat. 273 (Repealed Pub. L. 86-230, § 7, 1959)	15n.9
<i>Securities Act of 1933</i> (15 U.S.C. §§ 77a <i>et seq.</i> (1970))	
15 U.S.C. § 77 I (1970)	4, 31, 33
<i>Securities Exchange Act of 1934</i> (15 U.S.C. §§ 78a <i>et seq.</i> (1970))	3
15 U.S.C. § 78f(a)	19
15 U.S.C. § 78f(d)	7n.4, 19
15 U.S.C. § 78o(c)(3)	7
15 U.S.C. § 78cc(b)	31, 32

	Page
<i>Securities Investor Protection Act of 1970</i> (15 U.S.C. §§ 78aaa <i>et seq.</i> (1970))	1
15 U.S.C. § 78eee(a)(1),(2)	21
15 U.S.C. § 78eee(b)(1)(A)(iv),(v)	21
15 U.S.C. § 78fff(a)(3)	29n.14, 34
15 U.S.C. § 78fff(a)(4)	46
15 U.S.C. § 78fff(c)(1)	16n.10, 44, 46
15 U.S.C. § 78fff(c)(2)(A)(ii)	41, 42
15 U.S.C. § 78fff(f)(1)	29n.14, 35, 37
15 U.S.C. § 78ggg(d)	34-35
<i>Securities Act Amendments of 1975</i> , P.L. 94-29, §§ 5, 11, 15 U.S.C. §§ 78h, 78o (1975)	4n.2, 35
<i>Retirement Income Security Act</i> Pub. L. 93-406, 88 Stat. 829 (1974)	47n.18
<i>Del. Code Ann. Tit. 8, ch. 1, § 242(a)(4)</i>	43
<i>New York Uniform Commercial Code § 6-102(3)</i> (McKinney 1964), (McKinney Supp. 1976)	43n.17
<i>Smith-Hurd Ill. Rev. Stat. Ann. § 6-102(3)</i>	43n.17
<i>SEC Rule 15c3-1</i> , 17 C.F.R. § 240.15c3-1 (1976) ..	7n.4, 22
<i>SEC Rule 17a-5</i> , -10, 17 C.F.R. §§ 240.17a-5, -10 (1976)	21
<i>1934 Act Release No. 3617</i> (Nov. 8, 1944)	22
<i>Former NYSE Rule 325</i>	4, 7
<i>Former NYSE Rule 327</i>	8n.5
<i>NYSE Rule 416</i> , 2 CCH NYSE Guide ¶ 2416	8n.5
 BOOKS AND TREATISES:	
H. Braver, <i>Liquidation of Financial Institutions</i> §§ 317-18 (1936)	13, 14
3A W. Collier, <i>Bankruptcy</i> ¶ 64.02[4] (14th ed. 1975) ..	45
4A W. Collier, <i>Bankruptcy</i> ¶ 70.25[2] (14th ed. 1976) ..	43
1A A. Corbin, <i>Contracts</i> (1963)	
Section 194	13
Section 195	13n.7
Section 197	13, 17
Section 198	13
Section 200	13
Section 206	13

	Page
4 A. Corbin, <i>Contracts</i> (1951)	
Section 939	36
Section 940	37
3 L. Loss, <i>Securities Regulation</i> (2d ed. 1961)	32
<i>Restatement of Contracts</i> § 90 (1932)	13
<i>Restatement (Second) of Contracts</i> § 90(1) & Comment c, illustration 6 (Tentative Drafts Nos. 1-7 (1973))..	13
Uniform Commercial Code	
§ 6-102, Official Comment 3	43-44
§ 8-102	43
§ 9-105 (f)	43
E. Weiss, <i>Registration and Regulation of Brokers and Dealers</i> 57-68 (1965)	19
1 S. Williston, <i>Contracts</i> § 140 (3d ed. 1957)	13
12 S. Williston, <i>Contracts</i> 1518 (3d ed. 1970)	36

CONGRESSIONAL MATERIALS:

<i>Study of the Securities Industry, Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, Study of the Securities Industry, 92d Cong., 1st Sess., Part 2 (1971)</i>	19
<i>Securities Investor Protection Act of 1970: Hearings on H.R. 13308, 17585, 18081, 18109 and 18458 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 2d Sess. (1970)</i>	35
<i>Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93rd Cong., 1st Sess., Part II (1973)</i>	30
<i>Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971)</i>	19
<i>Securities Investor Protection Act Amendments of 1975: Hearings on H.R. 8064 Before the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce, 94th Cong., 1st Sess. (1975)</i>	31n.16
H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934)	19
H. R. Rep. No. 91-1613 91st Cong., 2d Sess., <i>reprinted in</i> [1970] U.S. Code Cong. & Ad. News 5254	34

ARTICLES:

	Page
Ames, <i>The History of Assumpsit</i> , 2 Harv. L. Rev. 1 (1889)	13n.7
Huff, <i>The Defrauded Investor in Chapter X Reorgani- zations: Absolute Priority v. Rule 10b-5</i> , 50 Am. Bankruptcy L.J. 197 (1976)	37
Slain & Kripke, <i>The Interface Between Securities Regu- lation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors</i> , 48 N.Y.U. L. Rev. 261 (1963)..	27, 30, 49
Wolfson & Guttr an, <i>The Net Capital Rules for Brokers and Dealers</i> , 24 Stanford L. Rev. 603 (1972)	20, 22

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket Nos.

77-6034, 77-6038, 77-6040, 77-6044, 77-6045, 77-6048, 77-6065

In the Matter of
WEIS SECURITIES, INC.,

Debtor.

GEORGE D. ALDRICH, et al.,

Claimants-Appellants,

—against—

EDWARD S. REDINGTON, Trustee, and SECURITIES
INVESTOR PROTECTION CORPORATION,

Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

JOINT BRIEF FOR APPELLEES

Preliminary Statement

Appellees Edward S. Redington, Trustee for the liquidation of the business of Weis Securities, Inc. ("Weis" or the "Debtor") pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* (1970) ("SIPA"), and the Securities Investor Protection Corporation ("SIPC") submit this consolidated brief in response to the four briefs submitted by appellants on these seven appeals.

These appeals involve the claims of eighteen claimants (the "Lenders"). The Lenders agreed, in contracts with the Debtor which were approved by and filed with the New York Stock Exchange, Inc. (the "Exchange") pursuant to statute and regulation, unconditionally to subordinate their claims for property loaned to the Debtor to the claims of all other customers and creditors in a liquidation proceeding such as this one. Alleging fraud in the inducement, each of the Lenders has claimed a right to rescind its agreement. For present purposes only, it is assumed that all the elements of fraud in the inducement could be proved by each Lender, unlikely as this appears to be in fact. All of the Lenders seek to be reclassified at the least as unsubordinated general creditors. Some Lenders seek to be treated as "customers" under SIPA¹ or to obtain some other type of priority or preferential treatment.

The case arises from a motion by the Trustee (joined in by SIPC) for summary judgment with respect to the Lenders' right to rescind, even assuming for this purpose that fraud could be shown to exist. The courts below differed on whether reliance on the Lenders' agreements by over 30,000 customers and creditors would have to be proved as a fact before the Lenders could be precluded from rescinding the subordination features of their agreements. Bankruptcy Judge Babitt held that reliance had to be proved. The District Court (Wyatt, J.) reversed, holding that proof of reliance would be unnecessary in this regulated industry where the Lenders' agreements permitted Weis to comply with net capital rules which were adopted for the protection of customers and creditors, and compliance with which was a *sine qua non* for Weis's remaining in business.

¹ Appellant Grossmann and the eleven appellants in No. 77-6045 (the "Winslow eleven") identified at the footnote to page 9 of Appellants' Joint Brief.

Mrs. Grossmann's argument that lenders who contracted to subordinate their property can, after rescission, be treated as "customers" entitled to preferential treatment is treated at pp. 40-41, *infra*. The Winslow eleven apparently feel that since this issue was not reached below, it will not be ripe for determination unless a right to rescind is established. (Joint Brief for Appellants at 9n.)

COUNTER-STATEMENT OF QUESTIONS PRESENTED FOR REVIEW

1. Whether in a liquidation of a member of the federally regulated securities industry, actual reliance by 30,000 members of the public who dealt with the firm must be proved as a fact to prevent its subordinated lenders from rescinding their subordination agreements, when the capital subordinated under those agreements was permitted by regulatory authorities to be included as part of the minimum, statutorily required net capital which allowed the firm to continue to deal with the public?

2. Whether the promises and representations made by each Lender directly to the *Exchange* in connection with becoming a subordinated lender may be rescinded because of the *Debtor's* alleged misconduct, when the Exchange relied on those promises and representations in: (a) approving each Lender's agreement (thereby allowing the Lenders to receive interest); and (b) allowing the Debtor to continue dealing with the public?

3. Whether appellant Grossmann, who has admitted that she understood she was making a loan to the Debtor, should be entitled to a priority with respect to funds invested in 1967 and 1969 and comingled with other property of the Debtor: (a) as a "customer" within the meaning of SIPA, (b) by application of the doctrine of "constructive trust"; or (c) by virtue of a bulk sales act?

4. Whether appellant Weis Voisin & Co., Inc. Employees' Profit-Sharing Plan and Trust may rescind on the theory that its beneficiaries, 334 former Weis employees, are entitled to "greater equity" in this liquidation?

STATUTES AND RULES INVOLVED

The pertinent provisions of SIPA, the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (1970) (the

"Exchange Act"),² and Section 12 of the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.* (1970) (the "Securities Act") relied on by the Lenders are set forth in a separate addendum to this brief. Rule 325 of the New York Stock Exchange (the "net capital rule") as it existed in 1973 also appears in that addendum.

COUNTER-STATEMENT OF THE CASE

What Is At Stake

It is common for a bankruptcy or liquidation to reveal or even result from misstatements in a firm's financial reports. The Lenders expressly promised to be subordinated to creditors and customers in the event of a bankruptcy or liquidation, no matter what its cause. The Debtor would not have been allowed to remain in business or deal with creditors and customers in the absence of these promises. The question is whether the Lenders may now be heard to rely on alleged misstatements in the Debtor's financial records to rescind their promises, when rescission will prejudice the creditors and customers who have claims in this liquidation.

In practical terms, the outcome of this litigation with the Lenders could determine whether more than nominal distributions can be made in the future to the Debtor's general creditors and customers. The eleven Lenders who claim to be "customers" under SIPA would receive a distribution substantially in excess of one million dollars if their position were sustained. Two other Lenders have attempted to claim priorities of one kind or another.

In addition to claims for priority treatment, the Lenders as a group assert that they may share at least on an equal footing with unsubordinated creditors in the general estate. The Len-

² Unless otherwise indicated, references to provisions of the Exchange Act are to those provisions as they were in effect prior to the Securities Acts Amendments of 1975, P. L. 94-29 (1975).

ders' claims aggregate over \$8 million—an amount sufficient to dilute any distribution that could be made to general creditors by approximately one-third.³

The Motion for Summary Judgment

The Trustee filed an application in April of 1974 in which he sought to have the Court rule that the claims of 52 of the Weis subordinated lenders — all of the subordinated lenders filing claims — were allowable, but only in a subordinated capacity in accordance with the terms of their agreements with the Debtor. (R. 26.) That application was necessary because several lenders had indicated an intention to repudiate their promises to remain subordinated.

A procedural hearing with respect to the Trustee's Application was held before the Bankruptcy Judge in July of 1974. (R. 48.) A majority of the subordinated lenders did not oppose the Trustee's application, and the Trustee's position with respect to these lenders was confirmed. The remaining Lenders each challenged in some way the validity of their subordination agreements.

The Trustee served on each of them an objection (see A-231-259) and motion for summary judgment with supporting affidavits (A-260-305) setting forth facts pertinent to the nature of the Lenders' agreements, their effect on the accounting treatment of Weis's capital and the role of the New York Stock Exchange in approving each of the agreements as a condition to its effectiveness. Some Lenders submitted opposing affidavits, but as the District Court found (A-412-13), they did not dispute the facts set forth in the affidavits in support of the Trustee's motion; rather, the opposing affidavits merely repeated allegations of fraudulent inducement and contained, at most, conclusory statements that the Lenders did not enter into

³ Claims totalling \$26 million have been filed against the general estate exclusive of subordinated claims. The Trustee estimates that allowable claims will ultimately amount to approximately \$22 million.

separate contracts with the Exchange (e.g., A-322) or were not conversant with all the details required for Exchange approval. (A-373.)

The Subordination Agreements

During the period from June 28, 1967 to May 7, 1973, each of the Lenders entered into an agreement or series of agreements under which it made loans of cash or securities to the Debtor for unrestricted use in the Debtor's business as a broker-dealer. Each agreement contained what the Bankruptcy Judge conceded were "express, unequivocal and unambiguous" promises (A-380) by which, in the event of a liquidation, the Lender agreed "irrevocably" to subordinate its claim for the property loaned to the claims of all other creditors of the Debtor and to waive any right to participate in the assets of the Debtor's estate until the claims of all other creditors had been satisfied in full. (See, e.g., A-168, 226, 268-69.) Each subordination agreement contained provisions which prevented the Lender from withdrawing its property before the expiration date of the loan without the written consent of the Exchange and precluded withdrawals even upon expiration when the Debtor was insolvent or in violation of the net capital rules. (A-167-68, 325-26, 268-69.)

The Exchange, acting as a regulatory authority for the benefit of the public, relied on the promises made by the Lenders in discharging its statutory duties. A prospective subordinated lender was required to submit a written application for approval to the Board of Governors of the Exchange. (A-303-04.) The terms of the subordination agreement had to be approved by the Exchange before the agreement became effective. (*Id.*) The agreement had to be accompanied by an opinion of counsel stating that the subordination provisions were valid and enforceable. (A-304.) A copy of the agreement itself had to be filed with the Exchange. (*Id.*)

These steps were all required by Exchange rules promulgated "in the public interest or for the protection of investors to

provide safeguards with respect to the financial responsibility" of broker-dealers. Exchange Act, Sec. 15(c)(3), 15 U.S.C. § 78o(c)(3). They were all followed in this case. (A-304.) Each of the Lenders involved in this appeal applied for Exchange approval, submitted the requisite documents and was in fact approved to become a subordinated lender to the Debtor by the Board of Governors of the Exchange. (A-304-05.) On the filing date of this liquidation, their agreements were on file with the Exchange and had not been repudiated.

The Role of Subordination Agreements Under Financial Responsibility Rules

Active participation by a regulatory body in the creation and supervision of these agreements was required because of the unique role played by subordinated loans in the calculation of "net capital" — the minimum capital required for a broker-dealer to remain in business. Exchange Rule 325, the Exchange's version of the "net capital rule,"⁴ limited the "aggregate indebtedness" of a member firm to fifteen times its "net capital." The Rule was promulgated by the Exchange in its statutory capacity as a self-regulatory authority and was intended to protect the public by preventing brokerage firms from incurring indebtedness out of all proportion to the liquid assets which could generate cash in the event of bankruptcy or liquidation. Compliance with the net capital rule was a *sine qua non* for Weis's staying in business and incurring the obligations

⁴ Rule 325 was promulgated by the Exchange in its capacity as a self-regulatory authority under Section 6(d) of the Exchange Act, 15 U.S.C. § 78f(d), and was approved by the SEC on the theory that it was "more comprehensive" than the SEC's net capital rule, SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1, applicable to over-the-counter broker-dealers. At the time in question, the SEC rule specifically precluded, as it does to this day, rescission of subordination agreements "by mutual consent or otherwise," if rescission would cause the broker to exceed the required ratio. Rule 15c3-1d(c)(1), 17 C.F.R. § 240.15c3-1d(c)(1). Rule 325 was extensively amended in 1976 to give brokers alternative means for achieving compliance.

to customers and creditors which are involved in its liquidation. A broker that is unable to comply with the Rule may be suspended from Exchange membership and forced out of business.⁵

One of the most significant aspects of both the SEC and the Exchange net capital rules has always been that in computing a member's "net capital" (net worth minus non-liquid assets), subordinated property is not treated as a liability but rather as an unencumbered capital asset. (A-296-97.) The treatment of subordinated property as an unencumbered asset is predicated on the assumption that such property will be available solely to satisfy claims of customers and creditors. This assumption is based in turn on the lender's promise to the broker and to the Exchange that its claim for the return of property will be unconditionally subordinated in the event of a liquidation. It is in exchange for this promise, and its attendant risks, that the lender receives generous interest payments.

Subordinated capital constituted the bulk of the "net capital" of the Debtor as it does for many member firms of the Exchange. In February, 1973, for example, the Debtor listed over \$19 million of subordinated capital, approximately \$3.5 million in shareholders' equity and approximately \$3.5 million in "retained earnings." (A-294.) The gravamen of the Lenders' unproven fraud claims is that the Debtor was grossly undercapitalized because the "retained earnings" and shareholders' equity figures were fraudulently overstated. It may thus be assumed that Exchange-approved subordinated capital constituted roughly three quarters of the Debtor's apparent "net capital" and all or virtually all of its actual capital.

⁵ See discussion at pp. 20-21, *infra*. Brokers were further required by former Exchange Rule 327 (as they still are by SEC regulation) to provide the Exchange with monthly reports stating their net capital and net capital ratio. See also Exchange Rule 416, 2 CCH NYSE Guide ¶ 2416.

Motivation For Subordination Agreements

One who volunteers to become an Exchange-approved subordinated lender receives rewards commensurate with the risks inherent in such an investment. The subordinated lender is deemed to be the beneficial owner of the securities and cash which he loans and thus is entitled to receive whatever dividends, interest, distributions or appreciation accrue in the normal course as well as being paid interest on the principal amount of the loan at attractive rates, often in excess of current prime interest rates. It is not unusual for a subordinated lender to have an effective rate of return on his investments nearly double that which he would otherwise receive. In exchange for their promises to subordinate, the Lenders as a group received approximately \$750,000 in interest payments from the Debtor prior to the advent of this liquidation. These interest payments do not include the dividends and interest payments which accrued on the subordinated property in the normal course. (A-273-75.)

Despite the collective zeal with which Claimants contend that they should be permitted to repudiate the subordination provision of their agreements, not one of the Claimants has tendered to the Trustee any of the interest received from the Debtor. In fact, prior to the advent of this liquidation, not one Lender had attempted to put the Exchange or the Debtor's customers and creditors on notice that its claim to the return of property was not effectively and unconditionally subordinated to the claims of all other creditors.⁶

⁶ For this reason, appellant Fidelity Corporation's alleged agreement with Weis to terminate the loan — of which there is no proof in the record — could not be effective as against the Exchange or customers and creditors with unsatisfied claims. Moreover, paragraph 7 of Fidelity's subordinated promissory note with Weis expressly provided that upon a termination such as that alleged by Fidelity, "payment of the [note] shall remain subordinate as hereinabove set forth." (A-190.)

Opinion of the Bankruptcy Judge

The Bankruptcy Judge held that public reliance on the Lenders' agreements would prevent the Lenders from repudiating those agreements (A-383), but nevertheless denied the Trustee's summary judgment motion on the ground that an "evidentiary hearing" (A-386) of some kind would have to be held to determine whether creditors—over 30,000 in number, including customers—actually relied on the subordination agreements or the net capital rule. (A-386-87.) The Bankruptcy Judge's opinion contemplated that the reliance issue would be tried before the Lenders established any ground for rescission but did not specify what showing of reliance—*i.e.*, reliance by one customer or creditor, all customers and creditors or some intermediate showing—would be required. (A-387.)

The Bankruptcy Judge also held that summary judgment was inappropriate with respect to the Trustee's argument that the Lenders had made direct promises to the Exchange which became binding, regardless of the Debtor's conduct, as soon as the Exchange relied upon them in approving the loans. (A-385-87.) The Bankruptcy Judge held that the Trustee would have to prove that each of the Lenders had entered a separate, bilateral "subordination agreement with the Exchange" before he could prevail on this theory. (A-387.)

The District Court Opinion

The District Court reversed the opinion of the Bankruptcy Judge. Judge Wyatt noted preliminarily that the Bankruptcy Judge's opinion left many questions unanswered as to the showing of reliance that had to be made and that, without further clarification of what the Trustee would be required to show, the procedure contemplated by the Bankruptcy Judge seemed "illogical and unworkable." (A-414.)

After reviewing the net capital rule, however, the District Court concluded that proof of actual reliance was unnecessary in this "much regulated" industry (A-408) because "[e]very customer and general creditor of Weis knew, or is presumed to

have known, that the broker-dealer business of Weis was regulated by federal law and that as part of such regulation the net capital rule was enforced Under the circumstances, actual reliance is not required to be shown. If the reliance doctrine must be satisfied as a point of dogma, it should be presumed as a matter of law." (A-418-19.)

Because of its ruling on the reliance issue, the District Court did not reach the Trustee's contractual estoppel argument and the question whether there was need for any further proof of an "agreement" with the Exchange beyond the Lenders' promises to the Exchange and the Exchange's undisputed reliance on those promises in computing the Debtor's net capital and allowing it to continue dealing with the public.

SUMMARY OF ARGUMENT

The opinion of the District Court should be affirmed. The Lenders cannot be allowed to repudiate their promises to the Debtor and regulatory authorities. The Lenders' promises enabled the Debtor to comply with the Exchange's net capital rule and therefore to continue dealing with the public. In liquidations of banks and financial institutions subject to similar capital regulations such promises and obligations have been regarded as absolute despite allegations of fraud in the inducement. Requiring the Trustee to prove actual reliance by any of the thousands of individual customers or creditors who did in fact deal with Weis would undermine the theory on which regulation of broker-dealers for the protection of the public has been based since 1934.

The Lenders are, moreover, estopped from repudiating their promises because those promises were not simply promises made to the Debtor but were also promises and representations made to the Exchange in its statutory capacity as a self-regulatory authority acting for the protection of the public. The Exchange relied on the Lenders' promises in approving the Lenders' property as good capital and allowing the Debtor to keep its doors open. The Exchange acquired independent rights

in the Lenders' promises to subordinate their claims; those rights may be enforced in this liquidation for the intended beneficiaries of the Lenders' promises—the innocent customers and creditors of Weis.

There is no merit to the separate arguments of appellants Grossmann and the employees' profit-sharing Trust. Their claims are not subject to any special equities. Many of Mrs. Grossmann's arguments are not consistent with the facts. Her arguments that she should become not only a general creditor but the beneficiary of a "constructive trust" or a "customer" are inconsistent with the SIPA statute. The Illinois bulk transfer statute by its terms has no conceivable application to this liquidation.

The Trust's argument that it should have priority status simply because its beneficiaries are former Weis employees ignores the fact that Congress has legislated on this subject and has exhausted its concern for employees in Section 64a(2) of the Bankruptcy Act.

ARGUMENT

I. CLAIMANTS CANNOT AS A MATTER OF LAW REPUDIATE PROMISES MADE TO PERMIT WEIS TO COMPLY WITH REGULATORY REQUIREMENTS AND CONTINUE DEALING WITH THE PUBLIC.

A. Reliance by Individual Creditors Need Not Be Shown in Regulated Industries Where the Promises Sought To Be Repudiated Were a *Sine Qua Non* for the Debtor's Dealing With the Public.

Both courts below recognized that a contract which contains a direct promise to creditors or regulatory authorities on which it was foreseeable that they would rely may be strictly enforced in bankruptcy and similar liquidations, even if there were some ground for regarding the contract as a nullity as

between the promisor and the debtor. *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942); *Lantry v. Wallace*, 182 U.S. 536 (1901); *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966); *Hurd v. Kelly*, 78 N.Y. 588 (1879); 1A A. Corbin, *Contracts* §§ 197, 200 at 219-20 (1963); H. Braver, *Liquidation of Financial Institutions*, §§ 317-18 (1936). This rule is simply a corollary to the common law principle⁷ that an otherwise unenforceable promise may be rendered enforceable by the reliance of the promisee or third party beneficiaries. *Brooklyn Trust Co. v. Fairfield Gardens, Inc.*, 260 N.Y. 16, 21, 182 N.E. 231, 233 (1932); *Best v. Thiel*, 79 N.Y. 15, 18 (1879) (rights of third party creditors in insolvency); *Spector v. National Cellulose Corp.*, 181 Misc. 465, 469, 48 N.Y.S.2d 234, 237 (Sup. Ct. N.Y. County 1943) (reliance by creditors on subordination agreement); *Restatement of Contracts* § 90 (1932); *Restatement (Second) of Contracts* § 90(1) & comment c, illustration 6 (Tentative Drafts Nos. 1-7)(1973); 1A A. Corbin, *supra*, §§ 194, 197-98, 206; 1 S. Williston, *Contracts* § 140 (3d ed. 1957). Where the promise or agreement is required as part of a legislative or regulatory scheme for the protection of creditors, reliance by creditors with unsatisfied claims against an insolvent debtor will be conclusively presumed to exist for reasons of public policy and enforcement will be automatic. *E.g.*, *Scott v. Deweese*, 181 U.S. 202, 213 (1901); *B. V. Emery & Co. v. Wilkinson*, 72 F.2d 10, 13 (10th Cir. 1934); *Julian v. Stewart*, 56 F.2d 32 (5th Cir. 1932); *Mount Vernon Trust Co. v. Bergoff*, 272 N.Y. 192, 5 N.E.2d 196 (1936).

⁷ This principle — which can ultimately be traced to the common law writ of *assumpsit* in the fifteenth century, see 1A A. Corbin, *supra*, § 195 at 198; Ames, *The History of Assumpsit*, 2 Harv. L. Rev. 1 (1889) — is incorporated in the common law applied by the federal courts, as well as the law of New York State and other states. See *Putnam Mills Corp. v. United States*, 432 F.2d 553 (2d Cir. 1970); *Porter v. Commissioner*, 60 F.2d 673, 675 (2d Cir. 1932), *aff'd*, 288 U.S. 436 (1933); *County Trust Co. v. Mara*, 242 App. Div. 206, 273 N.Y.S. 597 (1st Dep't 1934), *aff'd*, 266 N.Y. 540, 195 N.E. 190 (1935); 1A A. Corbin, *supra*, §§ 197 n.13, 206.

Banks and other financial institutions deal with the public in the same way as broker-dealers in securities and are or have been subject to analogous regulations regarding minimum capital; compliance with those regulations is typically enforced by regulatory authorities with whom reports demonstrating compliance with capital requirements are filed. In bank liquidations under both state and federal law, the principle of strict enforcement has been applied to preclude rescission as a matter of law, without any showing of reliance in fact by creditors or depositors. Reliance by the members of the public is conclusively presumed to exist from the pattern of state or federal regulation. *Lantry v. Wallace*, 182 U.S. 536, 552-53 (1901); *Scott v. Deweese*, 181 U.S. 202 (1901); *Anderson v. Cronkleton*, 32 F.2d 170 (8th Cir. 1929); *Ryan v. Mt. Vernon Nat'l Bank*, 224 F. 429 (2d Cir. 1915); *Hurd v. Kelly*, *supra*; *Best v. Thiel*, *supra*; *H. Braver*, *supra*, §§ 317-18.⁸ The District Court correctly applied the same rule to this liquidation.

In state bank cases, the capital represented by promissory notes or other obligations enabled a bank to pass a banking department examination or fulfill regulatory requirements designed to instill public confidence in banking institutions. Regulation was intended to assure financial stability, and without the apparent capital represented by the obligations, the bank would not have been able to continue operations. The courts have conclusively presumed that all depositors and creditors who dealt with the bank relied in good faith upon the apparent financial integrity of the bank. As stated by the New York Court of Appeals in *Hurd v. Kelly*, *supra*:

"... He [the obligor] knew that if the bond was treated as an asset and the bank thereby allowed to continue its business, new obligations to depositors would

⁸ For illustrative cases from other jurisdictions see, e.g., *Green v. Stone*, 205 Ala. 381, 87 So. 862 (1920); *Davis v. Burns*, 173 S.W. 476 (Ct. App. Tex. 1918).

be entered into on the faith of the solvency of the institution. Under such circumstances it would be gross injustice to permit the defendant, after having aided the bank to procure credit with the community, to avoid, as against depositors and creditors, the payment of his bond on the allegation that the exact condition of the bank was not disclosed to him, or that it was much worse than was represented. The dealings between him and the officials of the bank, at whose request he signed the bond, ought not, in justice, to be allowed to affect the security given by him for the protection of those dealing with the bank *and who must be presumed to have relied thereon in their dealings.*" (78 N.Y. at 597; emphasis added.)

The same principle has been applied to prevent shareholders in national banks from repudiating their obligations to pay a statutory assessment equal to the par value of their stock⁹ despite allegations of illegal conduct. As stated by the Supreme Court in *Scott v. Deweese, supra*:

"... [The defendant-shareholder] assumed the position, and claimed and exercised the rights, of a shareholder. He drew money from the bank as dividends upon his stock It may be—although upon this question we express no opinion—that the defendant, by proper proceedings instituted in good faith and in due time before the suspension of the bank, could have had his subscription cancelled But immediately upon the failure of the bank the rights of creditors attached

"The present suit is primarily in the interest of creditors of the bank. It is based upon a statute designed not

⁹ 12 U.S.C. § 64, Act of Dec. 23, 1913, c. 6, § 23, 38 stat. 273 (repealed Publ. L. 86-230, § 7, 1959). This statutory assessment was ultimately eliminated in 1933 by 12 U.S.C. § 64a (48 stat. 189) because Congress decided to alleviate the situation where, after several decades, stock subject to assessment had passed into the hands of heirs or other ignorant third parties and the cushion the assessment once provided had ceased to be meaningful.

only for their protection but to give confidence to all dealing with national banks in respect of their contracts, debts and engagements, as well as to stockholders generally. *If the subscriber became a shareholder in consequence of frauds practised upon him by others, whether they be officers of the bank or officers of the Government, he must look to them for such redress as the law authorizes, and is estopped, as against creditors, to deny that he is a shareholder, within the meaning of section 5151, if at the time the rights of creditors accrued he occupied and was accorded the rights appertaining to that position.*" (181 U.S. at 212-13; emphasis added.)

The last of the series of Supreme Court cases under this statute, *Oppenheimer v. Harriman National Bank & Trust Co.*, 301 U.S. 206 (1937), involved the rights of a shareholder *after* he had satisfied his statutory assessment in full. The shareholder had recovered a judgment for the original purchase price of the stock less dividends in an action commenced prior to the appointment of the receiver. The Court held that this judgment could share ratably with the claims of other creditors in the liquidation of the bank.¹⁰ The Lenders rely heavily on

¹⁰ It should be noted that the type of fraud claim permitted in *Oppenheimer* may neither be provable under § 63a of the Bankruptcy Act, 11 U.S.C. § 103a, nor allowable under Section 57d, 11 U.S.C. § 93d. See *In re Cartridge Television, Inc.*, 535 F.2d 1388, 1390-93 (2d Cir. 1976). The provisions of Sections 57d and 63a of the Bankruptcy Act are applicable to this liquidation under Section 6(c)(1) of SIPA, 15 U.S.C. § 78fff(c)(1). *In re F. O. Baroff Co.*, No. 76-5020, slip op. at 3484 (2d Cir. May 12, 1977); *In re Weis Securities, Inc.*, 542 F.2d 840 (2d Cir. 1976).

In *Oppenheimer*, by contrast, the statute authorized "ratable" distributions to all holders of "contracts, debts and engagements" — words which the *Oppenheimer* Court construed as "broad enough to include all pecuniary liabilities and obligations of the bank." *Oppenheimer v. Harriman National Bank & Trust Co.*, *supra*, 301 U.S. at 213. Here, the Lenders' fraud claims are inherently difficult of proof and have not been merged in a judgment as was the case in *Oppenheimer*.

Oppenheimer, but as the court below recognized that case supports the position of the Trustee. (A-420.) The *Oppenheimer* Court cited *Scott v. Deweese, supra*, with approval and left no doubt that the shareholder's obligation to pay the assessment upon insolvency—an obligation analogous to the Lenders' obligation to subordinate their claims upon Weis's insolvency or liquidation—was strictly enforceable even when fraud had been alleged:

“ . . . Plaintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status. Recognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment, plaintiff paid the amount laid against him.” (301 U.S. at 214; footnote omitted.)

Professor Corbin has summarized the principles of the bank cases in language equally applicable here:

“ . . . [T]here has been action in reliance on the note; action by the promisee bank, by bank examiners, by depositors and other creditors. *The members of the last named class may not know of the note's existence; but if it had not been given they might not have become creditors to the existing extent.*

“Bargains of the sort here considered may be fraudulent and illegal; and the bank's officers may be guilty of a crime in making them. This is not in itself a reason for denying enforcement in a suit by the bank. Rejection of the suit penalizes the wrong parties, the depositors and other creditors as well as innocent shareholders. Recovery by the bank merely makes the assets as much in reality as the illegal transaction caused them to appear to be.” (1A A. Corbin, *supra*, § 197, at 201-02; emphasis added.)

The same principles have been applied in other regulated industries where the circumstances made it appropriate. In

Julian v. Stewart, 56 F.2d 32 (5th Cir. 1932), a number of investors had been defrauded into purchasing the stock of an Alabama insurance company in exchange for a note secured by a mortgage for real property. The mortgage became part of the \$100,000 minimum capital required of insurance companies by Alabama law for the protection of policyholders. The insurance company, through no fault of the investors, became "hopelessly insolvent." (*Id.* at 32.) The investors proved a case of fraudulent inducement in the trial court and sought, as have Lenders here, "to change their status from that of stockholders to that of creditors, not only as to the corporation but as to its policyholders, and more, to appropriate to their claims as preferred creditors a part of the assets definitely and publicly pledged for the protection of policyholders." (*Id.* at 33.) There was no showing of actual reliance by policyholders beyond the fact that the insurance company had run up claims far in excess of its assets. Yet the court reversed a lower court decree in favor of the stockholders, stating in language equally pertinent to this appeal:

"Though then appellees have been defrauded, and nothing which they have done has sufficed to relieve the corporation itself from the consequences of that fraud, because the rights of the policy creditors to have the mortgage foreclosed and applied to their claims are paramount to any which appellees may assert, the decree may not stand." (*Id.* at 34.)

Accord, e.g., Ashton v. Glaze, 95 F.2d 427 (9th Cir. 1938).

In none of these cases did actual reliance by creditors have to be proved to exist to preclude rescission. Rather, reliance was conclusively presumed from the existence of a regulatory scheme established for the protection of creditors.

B. Claimants' Promises to Subordinate Were a *Sine Qua Non* for Weis's Dealing With the Public.

1. *The Debtor was Subject to "Net Capital" Rules Pursuant to Which It Obtained Large Amounts of Subordinated Capital for the Protection of Everyone with Whom It Would Do Business.*

The premise of regulation in the securities industry, as in industries such as banking and insurance, is that most members of the public will be ignorant of the complexities of a particular firm's financial condition. The net capital rule is supposed to provide some protection for all people who deal with a brokerage firm—the many people who do not understand the rule as well as the sophisticated traders who do.

In passing the Exchange Act, Congress recognized the vulnerable position of the vast majority of public investors who entrust their securities and cash to broker-dealers for participation in the securities markets, but who do not possess the sophistication or financial power to protect themselves from loss caused by the inadequate capitalization of a broker or dealer. See H. R. Rep. No. 1383, 73d Cong., 2d Sess. at 3 (1934). The net capital and other "financial responsibility" rules which the SEC and the Exchange are required by statute to promulgate are an integral part of the securities laws. They are intended to assure that broker-dealers will be able to meet their obligations to creditors, especially customers and other broker-dealers. See Exchange Act §§ 6(a) & (d), 15 U.S.C. §§ 78f(a) & (d); E. Weiss, *Registration and Regulation of Brokers and Dealers* 57-68 (1965); Securities and Exchange Commission, *Study of Unsafe and Unsound Practices of Brokers and Dealers*, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. 49-122 (1971); *Study of the Securities Industry, Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 92d Cong., 1st Sess., Part 2, at 782-89 (1971).

The net capital rule and the enforcement machinery that implements it are intended to shield the public from the continued operation of an inadequately financed broker. The certain availability of subordinated capital is regarded as vitally important; a sudden withdrawal could spell disaster both for the firm and its customers. See Wolfson & Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 Stanford L. Rev. 603, 625 n.153 (1972). If a broker-dealer suddenly encounters irremediable financial difficulties, the net capital rule is also intended to ensure that a "minimum cushion" of liquid assets will be available "as a margin of safety." *In re National Association of Securities Dealers Inc.*, 12 S.E.C. 322, 328 (1942). That, of course, is why the Exchange and the SEC insist on strict and total subordination to all customers and creditors in the event of bankruptcy or liquidation.

The importance of the net capital rule was well stated by the court in *Blaise D'Antoni & Associates v. SEC*, 289 F.2d 276 (5th Cir.), *cert. denied*, 368 U.S. 899 (1961):

"... The net capital rule is one of the most important weapons in the Commission's arsenal to protect investors. By limiting the ratio of a broker's indebtedness to his capital, the rule operates to assure confidence and safety to the investing public. . . ." (*Id.* at 277.)

Accord, e.g., Hughes v. Dempsey-Tegeler Co., 534 F.2d 156, 173 (9th Cir.), *cert. denied*, 97 S.Ct. 259 (1976).

Under the Exchange net capital rule applicable to Weis, a broker-dealer's "aggregate indebtedness" (essentially total money indebtedness other than subordinated loans) was not permitted to exceed 1500 percent of its "net capital" (essentially net worth less deductions for non-liquid assets). A broker-dealer was also required to maintain a minimum net capital in specified dollar amount. Member firms were required to file with the Exchange an audited year-end financial statement and monthly reports demonstrating that they were "in ratio," were examined periodically by Exchange personnel and faced even

more intense scrutiny if their capital ratio approached the minimum established by rule. See SEC Rules 17a-5, -10, 17 C.F.R. §§ 240.17a-5, -10.

"Congress did not intend to permit a broker to continue operations unless he had on hand cash or liquid assets in the required ratio to aggregate indebtedness." *In re Guy D. Mariannette*, 11 S.E.C. 967, 970 (1942) and citations therein. A broker-dealer is therefore not permitted to continue dealing with the public if it does not have sufficient net capital. The Commission may bring an action in a United States District Court to enjoin violations of financial responsibility rules including the net capital rule. See e.g., *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 981 (S.D.N.Y. 1973) (permanent injunction); *SEC v. G. L. Equities Corp.*, [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,624 (S.D.N.Y. 1972) (preliminary injunction). Failure to comply with the net capital rule may precipitate a SIPA liquidation if the financial condition of the broker-dealer has deteriorated to the point where customers are in need of SIPC protection. See SIPA §§ 5(a)(1),(2), 5(b)(1)(A)(iv), (v), 15 U.S.C. §§ 78eee(a)(1),(2), 78eee(b)(1)(A)(iv), (v). Indeed, violation of the net capital rule — not the allegations of fraud relied on by the Lenders — was the sole condition specifically alleged by SIPC in its application initiating this liquidation. (A-16.)

The role played by the net capital rule in ensuring public "confidence and safety" in the brokerage industry is analogous to that once played by the shareholder's "double liability" and similar statutes in the banking and insurance industries. The same rationale that estopped shareholders or obligors from repudiating their obligations in the liquidation of banking and insurance institutions without the need for proof of actual reliance by individual bank depositors, policy holders or other creditors should prevent the Lenders from repudiating their promises in this liquidation without the need for proof of actual reliance by thousands, hundreds or even one customer or creditor.

2. *Because of the Lenders' Promises, the Amounts Subject to Subordination Agreements Could Be Counted as Part of Its Net Capital.*

Under the net capital rule, a broker-dealer's obligations to repay loans of cash or securities made pursuant to subordination agreements are excluded from "aggregate indebtedness" and the loan proceeds are included in "net capital" as if owned outright by the broker-dealer. Thus the lender's promise to be subordinated transmutes what would otherwise be a liability into a capital asset. Wolfson & Guttman, *supra*, 24 Stanford L Rev. at 624. Subordinated capital enables a brokerage firm to remain in business only because regulatory authorities view subordinated lenders' promises as enforceable obligations. In the event of bankruptcy or liquidation, subordinated capital is one of the assets expected to be available to satisfy, not the claims of the subordinated lenders, but the claims of all other customers and creditors.

The SEC net capital rule specifically states that subordinated loan agreements cannot be rescinded "by mutual consent or otherwise." 17 C.F.R. § 240.15c3-1d(c)(1). Weis was not formally subject to this rule only because the Exchange rule was found by the SEC to offer customers and creditors even more complete protection. 1934 Act Release No. 3617 (Nov. 8, 1944).

These rules are intended to protect the vulnerable customers and creditors whose participation in the nation's capital markets Congress wished to encourage. The efficacy of the rules would be undermined if the customers and creditors whom Congress presumed to be ignorant had to be proved to have understood the Debtor's finances and the "esoteric provisions of the net capital rule." (Appellants' Joint Brief at 28.) The District Court recognized that all the analogous cases and every principle of "equity and fairness" (A-418) militated against such a perverse result. That determination should be affirmed.

C. The District Court Correctly Applied and Interpreted the *CIC* Case.

The Lenders cited all the cases cited in their Joint Brief to either the Bankruptcy Judge, the District Court or both, but the only case that gave either court pause was this Court's opinion in *In re Credit Industrial Corp.*, 366 F.2d 402 (2d Cir. 1966) (hereinafter referred to as the "*CIC* case"). The Bankruptcy Judge regarded the *CIC* case as "controlling" (A-382) on the question of need to prove reliance by senior creditors, even in the face of the net capital rules. The District Court analyzed the facts and language of that case (A-415-18) and reached the contrary conclusion. The District Court was correct.

What this Court said in *CIC* was this:

" . . . When a junior creditor establishes that the subordination agreement is unlawful, it *may* be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement, without actual or constructive knowledge of any infirmity in the agreement, in advancing funds to the bankrupt as a condition to receiving priority in the distribution of the bankrupt's estate." (366 F.2d at 409; emphasis added.)

As the District Court noted, the suggestion that proof of reliance might be relevant in the circumstances of the *CIC* case — circumstances which did not include a net capital rule or anything analogous to it—was not the holding of the case. The holding was that a valid subordination agreement would be enforced according to its terms without any showing of reliance by senior creditors. *Id.* at 408-09. The Court simply remanded to permit orderly pleading and development of claims for rescission and the defenses that might be asserted to them. *Id.* at 412. The Court did not rule on whether reliance—one of several possible defenses—had to be proved.

At most the language relied on by the Bankruptcy Judge and the Lenders suggested that it might be necessary in some

cases to have a factual showing with respect to reliance before a court could say that rescission was precluded. The Court did not hold or imply that such a showing would always be necessary.

CIC involved subordination provisions that had been negotiated with a relatively small number of institutional creditors, not provisions approved by regulatory authorities and required by law to run in favor of all present and future creditors and customers. As the District Court put it, "the motives for subordination were entirely private, having nothing to do with statutory requirements for a regulated business." (A-418.)

The District Court correctly reasoned that it would be anomalous to read *CIC* as requiring that a record of reliance by thousands of senior creditors be made by the Trustee in the "radically different" (A-417) circumstances of this case, where subordinated capital is held out as net capital available to pay claims of customers and creditors and is relied on by the Exchange in the performance of its public regulatory functions. Reliance by individual creditors and customers need not be proved when the Lenders' promises were the very thing that allowed the Debtor to keep its doors open and incur the millions of dollars of liabilities to all creditors and customers that are involved in this proceeding.

D. The Other Cases Cited by the Lenders Do Not Support Rescission of Subordination Agreements Subject to the Net Capital Rule.

1. *Cases Not Involving Obligations Intended to Ensure Financial Stability in Regulated Industries Cannot Support a Right of Rescission in This Case.*

The primary failing of the Lenders' rescission cases is that none of them involved rescission of a promise or obligation intended to allow a company to satisfy regulatory authorities that the firm was adequately capitalized and could remain in business. In most of the cited cases the shareholders had not

incurred obligations or made promises to regulatory authorities which were a condition of the debtor's being permitted to continue dealing with the public¹¹ These cases are simply not relevant to promises made pursuant to the net capital rules.

Most devastating to the Lenders' position, however, is the fact that in the cited cases in which such obligations had been incurred by shareholders, they were strictly enforced. In *Oppenheimer v. Harriman Nat'l Bank & Trust Co.*, *supra*, 301 U.S. at 214, the Supreme Court noted that the shareholder had fully discharged his obligation to pay an assessment upon the bank's insolvency, "[r]ecognizing that the bank's fraud and his rescission availed nothing against the comptroller's assessment." In *Salter v. Williams*, 244 F. 126, 130 (3d Cir. 1917), *appeal dismissed*, 250 U.S. 653 (1919), the stockholder had in fact "met his liability" prior to rescission. In *Clark v. Boston-Continental Nat'l Bank*, 84 F.2d 605, 607 (1st Cir. 1936), the plaintiffs had also "paid assessments levied against them as stockholders." *See also Williams v. Green*, 23 F.2d 796, 798 (4th Cir. 1918).¹² Ever since *Scott v. Deweese*, *supra*, the cases involving obligations or promises analogous to those incurred here by the Lenders have regarded those promises as absolute.

2. *Reorganization or Other Non-Bankruptcy Cases Cannot Support a Right of Rescission in This Case.*

The "right" of the defrauded shareholder to rescind in straight bankruptcy liquidations which the Lenders attempt to extract (Appellants' Joint Brief at 14-17) from *Oppenheimer*

¹¹ The State bank cases cited at page 37 of Appellants' Joint Brief did not involve assets that constituted part of the bank's minimum required capital. Moreover, those cases did not involve promises for which specific application to and approval by the regulatory authority was required.

¹² *Compare Florida Land & Imp. Co. v. Merrill*, 52 F. 77 (5th Cir. 1891). The Fifth Circuit subsequently explained the result of this case on the ground that the rescinded transaction involved was not a contribution to capital in the strict sense. *See Julian v. Stewart*, 56 F.2d 32, 34 (5th Cir. 1932).

and other non-bankruptcy liquidation cases such as *In re Four Seasons Nursing Centers of America, Inc.*, 472 F.2d 747 (10th Cir. 1973), and *In re Los Angeles Land and Investments Ltd.*, 282 F. Supp. 448 (D. Hawaii 1968), *aff'd per curiam*, 447 F.2d 1366 (9th Cir. 1971), is not supported by the cases. Such a principle would not be relevant to this case in any event.

Only one of the cited cases suggesting that a shareholder could rescind was a bankruptcy liquidation.¹³ Every other case is a Chapter X reorganization or a national bank liquidation. Fraud claims may be proved and allowed in Chapter X reorganizations because the very purpose of a corporate reorganization is to formulate a plan that will adjust all liabilities, thus permitting the debtor to survive. The court in the *Los Angeles Land* case, *supra* (Appellants' Joint Brief at 16), stated this principle as follows:

"Chapter X recognizes the necessity of recognizing claims which might not otherwise be provable in bankruptcy"

"In keeping with the fundamental purpose of effecting a rehabilitation of a financially embarrassed corporation by the reorganization of its creditor obligations and shareholders' interest it is essential to discharge all demands of whatever sort, executory and contingent, presently due or to mature in the future." (282 F. Supp. at 452; emphasis added; citations omitted.)

¹³ Some of the cases relied on by the Lenders do not even involve attempts to rescind purchases of the debtor's own stock; they involve attempts to rescind investment contracts or stock purchases in other enterprises sold by the debtor. That is true of the *Los Angeles Land* case, *supra*, cited at page 16 of the Joint Brief, *In re Rhine*, 241 F. Supp. 86, *rehearing denied*, 242 F. Supp. 127 (D. Colo. 1965), cited at page 16 and *SEC v. S. J. Salmon & Co.*, 375 F. Supp. 867 (S.D.N.Y. 1974), cited at page 34. These cases are no different from cases involving the right to rescind a purchase of goods from a bankrupt or insolvent vendor. They have nothing to do with the issues involved in this appeal.

As pointed out at note 10, *supra*, such contingent and unliquidated claims are not necessarily provable and may not be allowable in bankruptcy or SIPA liquidations because they will delay and frustrate other creditors. Orderly administration and fairness to trade creditors ordinarily require that such claims be asserted against the culpable individual parties. The controlling principles were stated by this Court in *In re Cartridge Television, Inc.*, 535 F.2d 1388 (2d Cir. 1976):

"... [T]he purpose of the [Bankruptcy] Act ... is to promote the prompt liquidation of each debtor's estate and the expeditious distribution of the proceeds to the bona fide general creditors holding provable claims so that they will not be forced to wait unduly long for payments due them. Furthermore, the contingent claimants here are not, and may never become, creditors of the corporate debtor. At this stage they remain stockholders. To permit them to delay the normal winding up of a corporate bankrupt's estate would be to undercut the utility of the bankruptcy laws where corporate debtors are involved. 'Not many doctrines have passed more fully into the collective consciousness of the legal and commercial communities than the absolute priority rule, which states this prohibition: in bankruptcy, stockholders seeking to recover their investments cannot be paid before provable creditor claims have been satisfied in full.' Slain & Kripke, *The Interface between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U.L. Rev. 261 (1973). By making contingent and unliquidated securities fraud claims both provable and nonexpungable, appellants' position would weaken severely the priority position of the general creditors. Shareholders who simply alleged securities law violations that were not patently frivolous could threaten substantial delay in the administration of a corporate bankrupt's estate. Given the often protracted

nature of securities litigation, it is not difficult to foresee trustees being forced to settle contingent claims of highly questionable merit in order to avoid unnecessary delays in distribution." (*Id.* at 1390-91.)

Significantly, in the one cited bankruptcy case where rescissionary claims were permitted, *Cawthon v. Bancokentucky Co.*, 52 F.2d 850 (W.D. Ky. 1931), the bankrupt had agreed to permit rescission of a stock purchase prior to bankruptcy, so that it took no feats of imagination for the court to find a "contract express or implied" that would give rise to a provable claim under Section 63a(4) of the Bankruptcy Act, 11 U.S.C. § 103a. Even so, the district court in *Cawthon* suggested that the shareholder's claim might ultimately be subordinated to the claims of non-shareholder creditors and would be subject to the defense of estoppel. 52 F.2d at 852-53.

In sum, there is simply no authoritative precedent holding that a shareholder, let alone a subordinated lender, may rescind on the ground of fraud and receive treatment equal or superior to that accorded general creditors in a bankruptcy or SIPA liquidation. Even if there were circumstances justifying creation of a bankruptcy right of rescission in other industries, that right should not be extended to subordination agreements subject to the net capital rules.

3. *The Aixala Case Does Not Support a Right of Rescission in this Case.*

One district court opinion cited by the Lenders (Appellants' Joint Brief at 42), did permit rescission of a subordinated loan agreement in the absence of a showing of reliance by creditors or customers. *Aixala v. W.E. Hutton & Co.*, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,981 (S.D.N.Y. 1975). Even assuming *Aixala* was correctly decided, it is clearly distinguishable here: the case did not involve a bankruptcy or liquidation.

In *Aixala*, all the lender's customers and branch offices had been transferred to another firm. *Id.* at 97,390. There was thus no showing that anyone's claim would be unsatisfied or that a

third party would be prejudiced in any way by permitting rescission. That is why the defendants in *Aixala* —the broker and its principals, not a trustee—could “point to no third-party creditors who relied” to their detriment on the subordination agreement. *Id.* at 97,392.

Here, by contrast, there is a SIPA liquidation. Seventeen hundred general creditors have filed claims totalling over \$26 million; one hundred customers still have unsatisfied claims totalling nearly \$1,000,000. SIPC, as subrogee of customers whose claims it has paid,¹⁴ has claims totaling another \$13 million. No other brokerage firm has taken over these claims. Their satisfaction will be prejudiced if rescission is permitted.

The Court need not reach the difficult issue of whether an Exchange-approved subordination agreement can ever be rescinded as *Aixala* assumed. The principle decisive of this appeal is that such an agreement cannot be rescinded in a bankruptcy-type liquidation when, in the words of the Supreme Court in *Scott v. Deweese*, 181 U.S. 202, 213 (1901), “the rights of creditors have accrued” under the net capital rule.

E. The “Legislative Developments” Cited by the Lenders Do Not Support Rescission in This Case.

The “recent legislative developments” emphasized by the Lenders (Appellants’ Joint Brief at 17) do not affect the principles applicable to this appeal. Much is made, for example, of the fact that one of the recent proposals for revision of the Bankruptcy Act included an express provision that rescinding

¹⁴ SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1). SIPC’s claims as subrogee cannot, as the Lenders imply, be considered less important than those of other creditors. Congress was concerned that SIPC recoup its cash advances to customers in order to avoid a drain on the treasury or additional costs to brokerage firms that would be passed on to customers. Congress made enforcement of SIPC’s rights of subrogation the third of the four purposes of a SIPA liquidation. SIPA § 6(a)(3), 15 U.S.C. § 78ff(a)(3). See point IG, *infra*.

shareholders would be subordinated to general creditors. See *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., Part II at 115-16 (1973). As seen in point D.2, *supra*, the case law does not support a general right to rescind by stockholders in bankruptcy liquidations, and thus the proposed subordination provision does not represent a change in existing law.¹⁵ What the proposal does tend to indicate, however, is that, as this Court recognized in *Cartridge Television, supra*, 535 F.2d at 1390-91, the rule which prevents stockholders from sharing equally with general creditors is the better rule. See also Slain & Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U.L. Rev. 261 (1963).

Accordingly, even if it were possible to cite case authority for the asserted general right of rescission by shareholders in bankruptcy, every consideration of policy and good sense militates against its extension to agreements entered pursuant to the net capital rules in brokerage house liquidations. As demonstrated above, such an extension of what the Lenders call the *Oppenheimer* "rule" of rescission would be inconsistent with the result of the *Oppenheimer* case.

Equally beside the point is that aspect of the proposed amendment to SIPA which would make it clear that a subordinated lender could under no circumstances be considered a "customer." The Lenders rely on this proposal as proof that rescission must be permissible under present law. (Appellants' Joint Brief at 19.) This reliance is disingenuous. As at least one of the Lenders' counsel well knows from having appeared at

¹⁵ Indeed, it was clearly contemplated in *Cawthon v. Bancokentucky Co.*, 52 F.2d 850, 852-53 (W.D. Ky. 1931), that shareholders, if not barred from rescinding by principles of estoppel, might at least be subordinate to general creditors after rescission. Accord, *In re Morris Bros.*, 293 F. 294 (9th Cir. 1923); *In re Recording Devices Co.*, 1 F.2d 474 (S.D. Ohio 1924), bankruptcy cases not cited by the Lenders.

some of the hearings,¹⁶ the impetus for this proposal was not any decided case, but the position taken by the Lenders in this proceeding.

The poverty of the Lenders' legislative history arguments is betrayed by their emphasis on statements in Bankruptcy Act revision hearings by SEC officials and the position adopted by the SEC with respect to Chapter X reorganizations. (Appellants' Joint Brief at 18.) The SEC has taken a much different position in this proceeding. Because of the importance of the net capital rule in broker-dealer regulation, the SEC did *not* contend below that rescission should be permitted because of fraudulent inducement. The policy of protecting customers embodied in the Exchange Act was recognized as more important than any possible right to rescind. Thus the SEC's position was that the net capital rules should absolutely preclude rescission, at least as insofar as rescission would prejudice customer interests. (Memorandum of Securities and Exchange Commission, January 31, 1975, supplemental designation of Record on Appeal, item 3.)

F. The Securities Laws Do Not Support Rescission in This Case.

The Lenders rely heavily on the rights to rescind fraudulently induced securities purchases codified and defined in Section 12 of the Securities Act, 15 U.S.C. § 77I, and Section 29(b) of the Exchange Act, 15 U.S.C. § 78cc(b). Even if this Court's decision in *Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), extends to all types of subordination agreements, the rescissionary rights defined in those statutes are not absolute and do not supersede the rights of innocent third parties.

¹⁶ *Securities Investor Protection Act Amendments of 1975: Hearings on H.R. 8064 Before the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce*, 94th Cong., 1st Sess. 153 (1975) (Statement of Charles H. Morin).

The rescissory remedies set forth in Section 12 of the Securities Act and Section 29(b) of the Exchange Act represent a codification, not an expansion, of the common law right of rescission. See *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 288 (1940); *Occidental Life Ins. Co. v. Pat Ryan & Assoc.*, 496 F.2d 1255, 1266 (4th Cir. 1974); *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1149 (2d Cir. 1970) (Friendly, J., dissenting). 3 L. Loss, *Securities Regulation* 1700-05 (2d ed. 1961). The statutes make contracts entered into in violation of their terms voidable, not void. Rights under both statutes are still subject to the intervening rights of innocent third parties. E.g., *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213 (9th Cir. 1962); *Straley v. Universal Uranium and Milling Corp.*, 289 F.2d 370, 373 (9th Cir. 1961); *Dale v. Rosenfeld*, 229 F.2d, 855, 859 (2d Cir. 1956); *Junker v. Midterra Associates*, 49 F.R.D. 310, 313 (S.D.N.Y. 1970).

Section 29(b) by its terms provides that a contract can be rescinded only against the other contracting party and third parties who "have acquired any right thereunder with actual knowledge of the facts" by which it could be voided. The statute thus unmistakably implies that such a contract may *not* be rescinded against innocent third parties, such as customers and creditors. As noted by the Supreme Court in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970):

"... This language establishes that the guilty party is precluded from enforcing the contract against an unwilling innocent party, but it does not compel the conclusion that the contract is a nullity, creating no enforceable rights even in a party innocent of the violation." (*Id.* at 387; footnote omitted.)

Judge Friendly set forth the correct analysis of both statutes in his dissent in the *Scudder & German* case, *supra*:

"... Despite the Draconian language, § 29(b) does not provide a pat legislative formula for solving every case

in which a contract and a violation concur. Rather it was a legislative direction to apply common law principles of illegal bargain, enacted at a time when it seemed much more likely than it might now that courts would fail to do this without explicit legislative instruction." (*Pearlstein v. Scudder & German*, *supra*, 429 F.2d at 1149.)

The Lenders' contention that their right to rescind under the securities laws exists apart from any equitable defenses was answered by the court in the *Straley* case, *supra*, an action under § 12 of the Securities Act:

"... Such defenses are available to one against whom an action at law is brought on a contract declared voidable by common law. On principle, we see no reason why such defenses would not likewise be available to one against whom an action is brought on a contract declared voidable by judicial construction of a statute. There is nothing in the language of Section [12] or its legislative history to indicate that Congress intended to create a right enforceable in law or in equity not subject to defenses available at law or in equity to an action based on a voidable contract. . . ." (289 F.2d at 373-74.)

Even the SEC argued below that the Lenders must be subordinated at the very least to the claims of customers without any proof of their reliance in fact and advocated a position under which the Lenders will not as a practical matter share in the general estate. The limited right of rescission codified in the securities laws cannot supersede the goal that this Court has called "[p]aramount in the scheme of federal securities legislation"—protection of the investing public through strict regulation of broker-dealers' capital. *Arneil v. Ramsey*, 550 F.2d 774, 783 (2d Cir. 1977).

The crux of this case, ignored throughout most of the Lenders' argument, is that Weis was a member of a heavily regulated industry. The Lenders' promises did not come into existence in a vacuum. They were made to allow a firm to

comply with the minimum, statutorily required financial responsibility rules promulgated by the Exchange and the SEC for the benefit of a public which is presumed to be ignorant of the minutiae of brokerage financing. They should be strictly enforced in the circumstances for which they were intended, just as the Banking Act assessments were strictly enforced in the circumstances for which they were intended.

G. SIPA Has Not Superseded the Net Capital Rules or Diminished the Importance of a "Cushion" of Subordinated Capital.

There is no merit to the Lenders' suggestion (Appellants' Joint Brief at 33) that the net capital rules have been superseded because Congress created SIPC to make cash advances up to limited dollar amounts to certain claimants. This suggestion completely ignores the interests of those creditors who are not entitled to SIPC cash advances (general creditors, brokers acting for their own account, persons associated with the debtor, even customers with claims over the SIPC limits) but who nevertheless were entitled to participate in the nation's capital markets through Weis on the congressionally sanctioned assumption that Weis had adequate capital to satisfy claims. Moreover, it ignores the interests of SIPC which, for important policy reasons, was given rights of subrogation by Congress. One of the purposes of this liquidation is to enforce those subrogation rights. SIPA Section 6(a)(3), 15 U.S.C. § 78fff(a)(3). See note 14, *supra*.

Congress was well aware of the net capital rules of the SEC and the Exchange when it wrote SIPA. It did not envision the Act as a substitute for existing regulations. Rather, it enacted SIPA as part of a legislative program which involved a tightening of the financial responsibility rules. *SIPC v. Barbour*, 421 U.S. 412, 415-16 (1975); H.R. Rep. No. 91-1613, 91st Cong., 2d Sess. 12 (1970), *reprinted in* [1970] U.S. Code. Cong. & Ad. News 5254, 5266; *see* SIPA Section 7(d), 15

U.S.C. § 78ggg(d). As Representative Keith said during the House hearings on the bill that became SIPA:

"What I am concerned about is that the cost of this and the need for it be as minimal as possible because of good regulation and strict requirements that should be followed. I want to be certain that the SEC and the self-regulatory agencies and broker-dealer firms themselves are strictly adhering to reasonable rules, that the hazard is lessened, and that therefore the cost of countering the condition is less." (*Securities Investor Protection Act of 1970: Hearings on H.R. 13308, 17585, 18081, 18109 and 18458 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 2d Sess. 213 (1970) (hereinafter cited as House Hearings).*)

In fact, since the advent of SIPA, Congress and the regulatory authorities have acted to revise and tighten the net capital rules still further. See *Securities Acts Amendments of 1975*, Pub. Law 94-29 §§ 5, 11, 15 U.S.C. 78(h), (o) (1975).

Congress did not adopt the deceptively simple solution of modelling SIPA liquidations entirely on the Federal Deposit Insurance Act or simply creating SIPC as a government-funded insurance company. See *SIPC v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1318 (2d Cir. 1976). Because of effective regulations, SIPC was expected to be able to recoup cash advances in the course of the liquidation as subrogee of the customers who received them. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1); *House Hearings* at 382 (remarks of Mr. McLaury, Deputy Undersecretary for Monetary Affairs of Treasury Department). SIPC was intended to be one of the chief beneficiaries of "good regulation" and the "strict requirements" of the net capital rules.

The Lenders' policy arguments based on the fact that "innocent investors" no longer pay assessments in bank liquidations (Appellants' Joint Brief at 32) are thus totally irrelevant. Bank assessments are no longer made because the statute

providing for such assessments has been repealed. No one repealed the net capital rules because of SIPA. SIPA was premised on their continued existence and enforcement.

II. THE LENDERS ARE BOUND BY THEIR PROMISES TO THE EXCHANGE, A SELF-REGULATORY AUTHORITY WHICH DID NOT PARTICIPATE IN ANY MISCONDUCT OF THE DEBTOR.

This case involves more than a bilateral contract between the Lenders and the Debtor. Each of the Lenders made direct promises not only to the Debtor, but also to the Exchange, which approved each of the agreements and each of the Lender's applications to become a subordinated lender. These promises included representations that the Lender's capital was unconditionally subordinated to the claims of general creditors and customers; would remain unconditionally subordinated in a liquidation such as this; could not be withdrawn prematurely without Exchange approval; and could not be withdrawn, even upon expiration of the agreement, if the Debtor's financial condition was such that creditors and customers might be injured thereby. Creditors and customers of the Debtor were the intended beneficiaries of these promises.

The Exchange was a direct promisee of these promises by the Lenders. Its rights to enforce the Lender's promises are independent of the Debtor's rights. *Peoples Trust Co. v. O'Neil*, 273 N.Y. 312, 316, 7 N.E.2d 244, 246 (1937); *Ball v. Shepard*, 202 N.Y. 247, 95 N.E. 719 (1911); *Berry Harvester Co. v. Walter A. Wood Mowing & Reaping Mach. Co.*, 152 N.Y. 540, 547, 46 N.E. 952, 955 (1897); *Insurance Co. of North America v. Brehm*, 257 Ore. 385, 393-94, 478 P.2d 387, 391 (1971); 4 A. Corbin, *Contracts* § 939 (1951); 12 S. Williston, *Contracts* § 1518 (3d ed. 1970). The independent rights of the Exchange are not affected by any misconduct of the Debtor. *Ball v. Shepard*, *supra*; *Insurance Company of North America v. Brehm*, *supra*.

Thus, without regard to the rights of the Debtor, the Lenders are bound by their representations to the Exchange that they would remain effectively and unconditionally subordinated in liquidation proceedings such as this one. Creditors and customers of the Debtor are third party beneficiaries of the Lenders' promises to the Exchange and could sue the Lenders to enforce those promises. *Pond v. New Rochelle Water Co.*, 183 N.Y. 330, 76 N.E. 211 (1906); *Spector v. National Cellulose Corp.*, *supra*. See 4 A. Corbin, *supra*, § 940, at 797. See generally Huff, *The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5*, 50 Am. Bankr. L. J. 197, 214 (1976). Both the Trustee and SIPC can demand that the subordinated Lenders' promises be enforced, the Trustee in his capacity as representative of the creditor body and as a hypothetical creditor under Section 70c of the Bankruptcy Act, 11 U.S.C. § 110c, SIPC in its capacity as subrogee of customers paid with SIPC cash advances. SIPA § 6(f)(1), 15 U.S.C. § 78fff(f)(1).

The Bankruptcy Judge recognized that the Exchange could have rights which were separate and distinct from the Debtor's own rights under the contract and which could be enforced by the Trustee as the representative of the third party beneficiaries. (A-387.) The Bankruptcy Judge nevertheless denied summary judgment on the theory that there was insufficient proof "that the subordinated lenders entered into a separate subordination agreement with the New York Stock Exchange." (*Id.*) Since the District Court held that summary judgment should have been granted by analogy to the bank cases and reversed on that basis, it never reached this separate contractual basis for insisting on strict enforcement of the Lenders' promises.

The Bankruptcy Judge erred in assuming that there had to be a formal subordination agreement between the Exchange and each Lender before the Exchange could acquire enforceable rights. The Trustee did not contend that there was "a separate subordination agreement with the New York Stock Exchange." The Trustee contended that each Lender made

promises or representations to the Exchange upon which the Exchange was entitled to rely, and on which it did rely, in approving the agreements and allowing the Debtor to include the Lenders' property in its net capital. Such promises are enforceable under the doctrine of promissory estoppel. See authorities cited at pages 12-13, *supra*.

In *Brooklyn Trust Co. v. Fairfield Gardens, Inc.*, 260 N.Y. 16, 182 N.E. 231 (1932), a lender had executed a subordination agreement in which it promised to subordinate its claims as mortgagee to a second possible lender which had previously agreed to lend funds to the mortgagor on condition that the second lender receive a first mortgage. The second lender did not sign the agreement with the first lender and was not required to do anything under its terms. Later, however, the second lender honored its agreement with the mortgagor. The court held that the first lender's promise to subordinate was enforceable as soon as the second lender made the contemplated loan, despite the fact that there was no present consideration for the promise and that other traditional elements of a bilateral contract were lacking. *Id.* at 21, 182 N.E. at 233.

Here the Lenders' promises became enforceable when the Exchange approved them and allowed the Debtor to add the amounts loaned to its net capital. There is no need for more "conclusive proof" of an agreement. (A-387.) It is indisputable that the Lenders made what the Bankruptcy Judge described as "express, unequivocal and unambiguous" promise: (A-380) to subordinate their claims. Each of the Lenders admits having signed an agreement containing these promises.

It is equally indisputable that the Exchange relied on the Lenders' promises. The Exchange reviewed and approved the applications of each Lender to become a subordinated lender; approved the Lenders' actual agreements; required opinions of counsel to ensure that the Lenders' promises to subordinate their claims would be valid and enforceable; and allowed the property contributed pursuant to the agreements to be included in the Debtors' net capital. (A-303-05.)

Finally, it is indisputable that reliance by the Exchange was foreseeable in an industry where the whole point of subordination agreements is to permit a broker-dealer to comply with the Exchange's net capital rule. The Lenders entered their agreements on Exchange-approved forms knowing that Exchange approval was required and after having applied to the Exchange for permission to become subordinated lenders.

As the Lenders hoped and expected, the Exchange approved the Lenders' agreements and allowed the Lenders' property to be counted in the Debtor's net capital. Because of Exchange approval, the Lenders were entitled to receive, and most did receive, handsome interest payments. Because of Exchange approval, the Debtor was permitted to continue dealing with the public and incurred the tens of millions of dollars of unsatisfied obligations that are involved in this proceeding. Nothing more need be shown to estop the Lenders from repudiating these promises to the Exchange.

III. APPELLANT GROSSMANN'S "SEPARATE AND ADDITIONAL" THEORIES FOR PREFERENTIAL TREATMENT ARE UNSOUND AND INCONSISTENT WITH THE FACTS.

Appellant Grossmann argues that, notwithstanding the principles of law that prevent other Lenders from rescinding *vis-a-vis* customers and creditors, there are "separate and additional issues" (Grossmann Brief, p. 1) which should allow rescission or priority treatment in her case. One cannot help but feel sympathy for the facts of Mrs. Grossmann's life as she has related them, but unfortunately, in a large bankruptcy or SIPA liquidation not everyone with a sympathetic claim can be made whole or given priority treatment. *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 983 (2d Cir. 1974), *quoted in SIPC v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1317 n.4 (2d Cir. 1976).

A. Mrs. Grossmann's Factual Ground for Rescission Is No Better Than Anyone Else's; She Understood She Was Making a Contribution of Capital to the Debtor.

The Grossmann brief contains several arguments which seem to be based on the assumption that Mrs. Grossmann did not understand the nature of her investment or was perhaps misled into investing in Weis rather than in making investments in publicly listed stocks through Weis. (E.g., Grossmann Brief, pp. 9-10, 18-23, 28-29.) These arguments simply do not accord with the facts stated in her affidavit.

Although Mrs. Grossmann did aver that she was not sophisticated in financial matters, she also alleged that she had invested \$20,000, in exchange for "the highest interest," in "securities of Weis, Voisin & Cannon" and that the Weis officer with whom she dealt "explained to me that the loan was like a loan to the company" (A-337):

"... I thought at the time of the investment that these debentures were really nothing else but shares of stock in Weis, Voisin & Cannon, and that I owned stock in the company." (*Id.*)

Over the course of the succeeding years she received a subordinated debenture in the amount of \$15,000 from Weis and several other documents reflecting that her entire \$20,000 investment was "subordinated." (A-146-48; A-150-51.)

Mrs. Grossmann invested \$15,000 in Weis in 1967 and an additional \$5,000 in 1969 — long before the acts of fraud alleged by other Lenders took place. Her investment was relied on by regulatory authorities as part of the net capital of the Debtor for nearly six years. During those six years she received interest on the investment equal to nearly half of the amount subordinated.

Mrs. Grossmann's grievance is that she made what has proved to be, after six years, an unfortunate investment. Her rights are certainly no better than those of the other Lenders.

B. Mrs. Grossmann Was Never a Customer of Weis.

As all the other Lenders agree, Mrs. Grossmann's argument that she should be treated as a "customer" of Weis is not ripe for review until a right to rescind is established. See note 1, *supra*. Therefore, in order to avoid burdening the Court, the Trustee and SIPC will discuss the point only briefly.

If the law were as contended by Mrs. Grossmann, further facts would have to be developed at trial. On its face, however, the argument appears to be indefensible under SIPA Section 6(c)(2)(A)(ii), 15 U.S.C. § 78fff(c)(2)(A)(ii), and this Court's decisions in *SIPC v. Executive Securities Corp.*, Docket Nos. 77-6005, 77-6009 (2d Cir. May 20, 1977) slip op. at 3695 and *SEC v. F.O. Baroff Co.*, 497 F.2d 280 (2d Cir. 1974).

The term "customer" is defined in Section 6(c)(2)(A)(ii) of SIPA, 15 U.S.C. § 78fff(c)(2)(A)(ii), to *exclude*

"any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor."

Here the money loaned by Mrs. Grossmann (and money or other property loaned by other Lenders) was, by contract, subordinated to the claims of Weis' creditors and had become part of its capital. If there were a right to rescind, the rescinding subordinated lender would not be allowed to leapfrog into the preferred customer class and be treated as if he or she had been an ordinary customer who had never agreed to be subordinated. Even the Lenders' reading of *Oppenheimer* and the Chapter X cases they cite at best permit the rescinding investor to share on an equal footing with general creditors.

In Mrs. Grossmann's case, the best that she can say is that, while she may never have precisely understood that she was subordinated to other creditors, she did understand that she was making a loan to be used as capital by Weis. In her own words, she thought she had bought "shares of stock in Weis." (A-337.)

In the *Baroff* case, *supra*, this Court held that someone who had made a temporary loan of securities to help a debtor "out of a cash bind" could not be considered a "customer" under Section 6(c)(2)(A)(ii) of SIPA, 15 U.S.C. § 78ff(c)(2)(A)(ii), even though there had been no specific agreement to subordinate that loan or purchase capital stock in the Debtor. 497 F.2d at 284. Here appellant's position is far weaker. The best she can say is that she thought she was buying stock in Weis. That is enough to prevent her from receiving customer treatment under the statute.

C. There Is No Ground for Asserting a "Constructive Trust" and Nothing to Which Such a "Constructive Trust" Could Attach.

There is no reason to assume that Mrs. Grossmann could be entitled to a "constructive trust" under Illinois or any other law or that such a doctrine could give her a priority over other creditors in bankruptcy.

In the first place, Mrs. Grossmann cannot establish that anyone took money from her "deceitfully" or under false pretenses. (Grossmann Brief at 17.) She understood that she was making a capital investment in Weis. For six years she received a high rate of return on that investment. Her investment eventually went bad for reasons no one could foresee in 1967. Even if Weis or Mr. Meiselman were in a "confidential" relationship with Mrs. Grossmann (a factual matter not conceded by SIPC or the Trustee), it is difficult to see how they abused it.

Moreover, there is nothing to which a constructive trust could attach. Mrs. Grossmann sent the money for her subordinated debentures to Weis many years before its demise, and that money became part of its working capital. A subordinated account was opened for Mrs. Grossmann on Weis's books, but no funds were segregated for her account. Accordingly, there is no fund of property to which Mrs. Grossmann can trace. See *United States v. Randall*, 401 U.S. 513 (1971); *In re Faber's*,

Inc., 360 F. Supp. 946 (D. Conn. 1973); 4A W. Collier, *Bankruptcy* ¶ 70.25[2] (14th ed. 1976).

At most, if the law permitted a subordinated lender to rescind in this industry, and if Mrs. Grossmann could show facts establishing her right to rescind, she would have a general creditor claim of \$20,000 —subject, of course, to tender of the interest she received during the six years when her investment in Weis was profitable.

D. Mrs. Grossmann Can Claim No Rights Under the Illinois Bulk Sales Act.

The short answer to Mrs. Grossmann's allegation that she has special equities under the Illinois or some other bulk sales act is that she is unable to allege any facts from which it may be inferred that a bulk sale took place. As a matter of fact, everyone else acknowledges that the Debtor, Weis Securities, Inc., is the same company as the company with which Mrs. Grossmann dealt in 1967 and 1969. (See, e.g., A-22, A-114, A-193, A-202.) Weis's name was simply changed to Weis Securities, Inc. on April 9, 1973 under § 242 of the Delaware Corporation Law, Del. Code Ann. Tit. 8, Ch. 1, § 242(a)(4).

An equally short answer is that neither the Illinois nor any other bulk sales act *could* apply to Weis. Section 6-102(3) of the Uniform Commercial Code — as in force in both New York and Illinois in 1973¹⁷—defined the companies to which the bulk sales provisions applied as "those whose principal business is the sale of merchandise from stock" Weis's principal business was to act as a broker in transactions in "investment securities" (UCC § 8-102), not to sell "goods" or "merchandise" from its own "stock." See UCC § 9-105(f). Official

¹⁷ New York Uniform Commercial Code § 6-102(3) (McKinney 1964); Smith-Hurd Ill. Rev. Stat. Ann. § 6-103(3). The New York statute was amended in 1974 to include rentals, as well as sales, of merchandise and to include restaurants. New York Uniform Commercial Code § 6-102(3) (McKinney Supp. 1976).

Comment 3 to UCC § 6-102 notes that the bulk sales act was intentionally drafted not to cover transfers of "investment securities" and other intangible property because the bulk sales risk was considered slight. *See generally, Standard Milling Co. v. Yoss*, N.Y.L.J. April 8, 1975, p. 2, col. 1, 16 UCC Reporting Service 815 (Sup. Ct. New York County April 8, 1975.)

Finally, even if there had been a "bulk sale," virtually every other creditor of Weis could make the same argument Mrs. Grossmann makes. Her only remedy against a bankrupt transferee is to file her claim against the assets held by the Trustee along with everyone else. The only effect of the bulk sales act in these circumstances might be to give her and other creditors of the hypothetical transferee rights against the hypothetical transferor to the extent the "bulk sale" was fraudulent or unfair.

IV. THE TRUST CANNOT BE TREATED MORE FAVORABLY THAN OTHER SUBORDINATED LENDERS.

The employees' profit-sharing Trust subordinated nearly \$100,000 to Weis in November, 1972 under an Exchange-approved agreement similar to those entered into by the other Lenders. (A-195-97.) The Trust argues that the principles of law applicable to its claim are different from those applicable to the claims of other Lenders because the Trust's beneficiaries are 334 former employees of the Debtor and those employees will ultimately receive distribution of any amounts paid to the Trust. Congress provided a limited priority for employees' wage claims of up to \$600 in Section 64a(2) of the Bankruptcy Act, 11 U.S.C. 104a(2) (1970), applicable to this proceeding by virtue of SIPA § 6(c)(1), 15 U.S.C. § 78fff(c)(1). The authorities cited in the Trust's own brief make it clear that this is the limit of Congress' special concern for employees. The Trust's subordinated claim cannot be treated differently from any other subordinated claim.

A. Priorities Among Creditors Can Be Established Only by the Provisions of the Bankruptcy Act

Although a bankruptcy court may consider equitable principles in subordinating or disallowing claims, *Pepper v. Litton*, 308 U.S. 295 (1939), it is well established that these principles cannot be considered to create priorities between creditors of the same class. *In re Delaware Hosiery Mills*, 202 F.2d 951 (3d Cir. 1953); *United States v. Killoren*, 119 F.2d 364 (8th Cir.), cert. denied, 314 U.S. 640 (1941); *In re Columbia Ribbon Co.*, 117 F.2d 999 (3d Cir. 1941); 3A W. Collier, *Bankruptcy*, ¶ 64.02 [4] at 2073-74 (14th ed. 1975). The reason for this distinction is that Section 64 of the Bankruptcy Act provides the exclusive method of determining priorities among creditors.

As the court explained in *In re Columbia Ribbon Co.*, *supra*:

"... [T]he court in determining the priority of claims against the estate is bound by the provisions of Section 64 [of the Bankruptcy Act] which specify the classes of debts which are to have priority of payment over general creditors of a bankrupt estate and the order of their payment with respect to each other. . . .

"The referee and the court below grounded their action in granting priorities within the class of administration expenses upon what they believed to be the equitable powers of a court of bankruptcy. . . . But these equitable powers are to be exercised within the limits laid down by the Bankruptcy Act and subject to its specific provisions. The court may not by granting a priority which it deems equitable set aside the clear congressional mandate that no such priority shall be accorded. *Pepper v. Litton* . . . is not to the contrary. That case holds that a court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy. . . . It does not hold that the court may set up a sub-classification of claims within a class given equal priority

by the Bankruptcy Act and fix an order of priority for the sub-classes according to its theory of equity. (117 F.2d at 1001-02; citations omitted; emphasis added.)

See also SEC v. Packer, Wilbur & Co., 498 F.2d 978, 983 (2d Cir. 1974); *SIPC v. Morgan, Kennedy & Co.*, 533 F.2d 1314, 1317 (2d Cir. 1976).

In re Penn Central Transportation Co., 484 F.2d 1300 (3d Cir. 1973), *cert. denied*, 415 U.S. 951 (1974), relied upon by the Trust, is not to the contrary. That case did not involve priorities in bankruptcy. It dealt with payments from an unfunded pension plan during a railroad reorganization. Finding that these payments were a tradition in the industry, the Court "justified such payments as necessary to preserve the morale of present and future employees" (484 F.2d at 1304) in order to keep the railroad operating during reorganization. This consideration is totally irrelevant in a SIPC liquidation. The Debtor is not to be rehabilitated in this proceeding, but liquidated. SIPA § 6(a)(4), 15 U.S.C. § 78fff(a)(4). The Court is expressly precluded from entering a plan of reorganization by SIPA § 6(c)(1), 15 U.S.C. § 78fff(c)(1). Ordinary bankruptcy principles, and not the policies unique to railroad reorganizations, apply to this SIPA liquidation.

B. The Trust Is Not Entitled to Priority Pursuant to Section 64 of the Bankruptcy Act.

The Bankruptcy Act has had a long-standing policy of according special status to employee claims; however, this priority status is limited to claims in the amount of \$600 for "wages . . . due to workmen" as provided in Section 64(a)(2), 11 U.S.C. § 104(a)(2). The 334 beneficiaries of the Trust will be given priority treatment in this liquidation for such "wages" owing to them on the filing date. They are not entitled to a second priority for claims that the Trust might have against Weis, especially since those claims were subordinated ones.

In the leading case of *United States v. Embassy Restaurant, Inc.*, 359 U.S. 29 (1959), the Supreme Court considered and rejected the contention that contributions to a profit sharing plan could fall within Section 64a, even when there was no question of the plan having subordinated its rights:

"The trustees attempt to bring contributions within this preferred class by claiming them to be 'wages . . . due to workmen.' This class of claims has been given a preferred position in the Bankruptcy Act for over 100 years [T]he Congress has amended the Act, but such amendments have been few and guarded ones If it had wished to include contributions [to profit sharing plans], Congress could easily have included them at any of these times. . . . It is therefore evident that not all types of obligations due employes from their employers are regarded by Congress as being within the concept of wages, even though having some relation to employment. . . ." (359 U.S. at 31-32.)

This holding was reiterated nine years later in *Joint Industry Board v. United States*, 391 U.S. 224 (1968), where the Supreme Court further emphasized the significance of the Congress's refusal to expand upon the clear wording of Section 64. The Court noted that "although [section 64] was completely re-enacted in 1967, [it] was left unchanged despite the fact that in every Congress since *Embassy Restaurant* bills have been introduced to overrule or modify the result in that case." (391 U.S. at 228; footnotes omitted.) The Court concluded that "[i]f there is still any question as to whether claims for unpaid contributions to provide deferred benefits to employees should share the . . . limited priority granted wages due to workmen, any new resolution of that question should come from Congress." (391 U.S. at 229.)¹⁸

Thus, the Supreme Court has spoken definitively on the point in question and has held that claims such as the one

¹⁸ Section 2 of ERISA, Pub. L. 93-406, 88 Stat. 829 (1974), relied on at pages 6 and 7 of the Trust's Brief to change the result of *Embassy Restaurant*, has no bearing on the classification of claims in bankruptcy. Moreover, that statute did not come into existence until a year after this liquidation began.

asserted by the Trust are not entitled to any special priority even when they are not subordinated. *A fortiori*, the Trust's subordinated claim cannot be entitled to priority treatment.

V. RELIANCE BY CUSTOMERS AND CREDITORS SHOULD AT LEAST BE PRESUMED TO EXIST AND ANY REQUIREMENT OF A SHOWING ON THAT ISSUE BY THE TRUSTEE SHOULD AWAIT PROOF OF FACTS ENTITLING LENDERS TO RESCIND.

As the District Court noted, the decision of the Bankruptcy Judge left "far from clear" (A-414) the type of showing that the Trustee was required to make as to reliance and also adopted the "illogical and unworkable" procedure (A-414) of requiring a trial on the reliance issue before facts entitling the Lenders to rescind were established. Since the District Court reversed the Bankruptcy Judge on the ground that the net capital rule made any further showing of reliance extraneous, it did not address these questions. If this Court reverses the District Court, it should remand with instructions as to when, how and by whom reliance or its absence is to be established.

If any substantial further showing of reliance must be made by the Trustee, trial of that issue should take place only after at least one of the Lenders has established at a trial the facts entitling him to rescind. This is the clear import of this Court's opinion in the *CIC* case in which the Court stated:

" . . . When a junior creditor *establishes* that the subordination agreement is unlawful, it *may* be reasonable and necessary, if equity is to be done, to require a senior creditor to prove that he relied on the subordination agreement. . . ." (*In re Credit Industrial Corp.*, 366 F.2d 402, 409 (2d Cir. 1966); emphasis added.)

The Bankruptcy Judge's proposed disposition unnecessarily and unfairly forces the Trustee to expend resources on proof of an issue which becomes relevant only when one or more Lenders discharges the burden of proving fraud in the in-

ducement which is the first premise of any alleged right to rescind.

It is entirely inappropriate, moreover, that the burden of inquiring into the mental state and subjective intentions of creditors and customers in order to prove reliance should fall on the Trustee. This is, after all, a "much regulated" industry. (A-408.) If the federal regulatory structure, and particularly the net capital rule, does not absolutely preclude rescission in circumstances such as the present, customers and creditors should at least be presumed to have relied on the efficacy of the government regulations intended to protect them. If there is any question of reliance in fact, the Lenders should have the burden of proving that the regulatory scheme has not in fact contributed to public confidence in the brokerage industry and that customers and creditors did not rely on the net capital rules or on the "cushion" of the Debtor's subordinated capital as reflected in the financial statements distributed to the public. (A-279-94.)

The commentators cited by the Lenders have advocated that reliance on investors' capital should be presumed to exist, even in industries not subject to a net capital rule, and that rescinding shareholders should have the burden of overcoming that presumption. Slain and Kripke, *The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261, 288-91, 294 (1973), cited at page 17 of the Appellants' Joint Brief. In this industry, it is difficult to see why any showing of reliance is required beyond the fact that millions of dollars of unsatisfied claims were incurred by the Debtor while it was allowed to do business because it apparently had enough subordinated capital to satisfy the net capital rule. If a further record is required because of the Lenders' speculations about what might or might not have passed through the minds of Weis's customers and creditors (Appellants' Joint Brief at 28), the Lenders ought at the least to have the burden of disproving what would otherwise be assumed — that customers and creditors relied on a system of financial regulation established for their benefit.

CONCLUSION

For the foregoing reasons, further proof of reliance by customers and creditors would be irrelevant as a matter of law, and the opinion and order of the District Court should be affirmed. If the decision is not affirmed, the case should be remanded to the District Court with instructions that the Lenders prove absence of reliance by customers and creditors as part of their affirmative case, and that any showing on the reliance issue by the Trustee await proof of facts that would entitle each Lender to rescind.

Dated: New York, New York
June 10, 1977

Respectfully submitted,

HUGHES HUBBARD & REED

Attorneys for Appellee Edward S.
Redington, Trustee for the liqui-
dation of the business of Weis
Securities, Inc.

One Wall Street
New York, New York 10005

James W. Giddens
James B. Kobak, Jr.
David W. Wiltenburg,
Of Counsel

THEODORE H. FOCHT
General Counsel

Attorney for Appellee Securities In-
vestor Protection Corporation
900 Seventeenth Street, N.W.
Suite 800
Washington, D.C. 20006

Wilfred R. Caron
Associate General Counsel
Michael E. Don
Senior Attorney,
Of Counsel

ADDENDUM OF STATUTES

Securities Act of 1933

Sec. 12 (15 U.S.C. § 771)

"Any person who

"(1) offers or sells a security in violation of section 5,
or

"(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission) and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

*Securities Exchange Act of 1934**

Sec. 6 (15 U.S.C. § 78f)

"(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section,

* The provisions of the Securities Exchange Act of 1934 are set forth as they were in effect prior to the Securities Acts Amendments of 1975, P.L. 94-29 (June 4, 1975).

by filing a registration statement in such form as the Commission may prescribe, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

“(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title, and any amendment thereto and any rule or regulation made or to be made thereunder;

“(2) Such data as to its organization, rules or procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

“(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the ‘rules of the exchange’; and

“(4) An agreement to furnish the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

“(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principals of trade.

“(c) Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any

rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

“(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

“(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission’s deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

“(f) An exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.”

Sec. 8 (15 U.S.C. § 78h)

“It shall be unlawful for any member of a national securities exchange, or any broker or dealer who transacts a business in securities through the medium of any such member, directly or indirectly—

“ . . .

“(b) To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons,

including customers' credit balances (but excluding indebtedness secured by exempted securities), to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but not exceeding in any case 2,000 per centum, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors.

Sec. 15(c) (15 U.S.C. § 78o(c))

"(3) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities, and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall require the maintenance of reserves with respect to customers' deposits or credit balances, as determined by such rules and regulations."

Sec. 29 (15 U.S.C. § 78cc)

"...

"(b) Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation there-

under, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of Section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation."

Securities Investor Protection Act of 1970

Sec. 6(c)(2) (15 U.S.C. § 78fff(c)(2)).

"(A) Definitions.—Except as otherwise expressly provided in this section, for purposes of this section and the application of the Bankruptcy Act to a liquidation proceeding—

" . . .

"(ii) 'customers' of a debtor means persons (including persons with whom the debtor deals as principal or agent) who have claims on account of securities received, acquired, or held by the debtor from or for the account of such persons (I) for safekeeping, or (II) with a view to sale, or (III) to cover consummated sales, or (IV) pursuant to purchases, or (V) as collateral security, or

(VI) by way of loans of securities by such persons to the debtor, and shall include persons who have claims against the debtor arising out of sales or conversions of such securities, and shall include any person who has deposited cash with the debtor for the purpose of purchasing securities, but shall not include any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor;"

Rules of the New York Stock Exchange

Rule 325.

"(a) No member or member organization, doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtness to exceed 1500 per centum of his or its Net Capital, which Net Capital shall be not less than \$100,000 in the case of a member organization which carries any accounts for cutsomers

"(b) For the purpose of this rule—

"(1) The term 'proprietary accounts' shall include capital accounts of partners or sole proprietor, investment and trading accounts, participations in joint accounts, accounts of partners which are covered by agreements, approved by the Exchange, providing for the inclusion of equities therein as partnership property and borrowings covered by subordination agreements approved by the Exchange;

"(2) the term 'Aggregate Indebtedness' shall include the total money liabilities of the member or member organization in all accounts other than customers' and

brokers' accounts for commodity future contracts; plus equities in customers' and brokers' accounts for commodity future contracts; plus the market value of securities borrowed (other than for delivery against customers' sales) for which no equivalent value is paid or credited, exclusive of the following:

"(A) money borrowed (adequately collateralized) on securities, spot commodities or other assets owned by the member, member firm or general partner thereof, or a member corporation and on those subordinated to general creditors;

"(B) money payable against securities loaned which are owned by the member, member firm or general partner thereof, or a member corporation and those subordinated to general creditors;

"(C) money payable against securities failed to receive in connection with transactions for the account of the member, member firm or general partner thereof, or a member corporation and for accounts subordinated to general creditors;

"(D) money borrowings adequately collateralized by securities exempted from registration under the Securities and Exchange Act of 1934, otherwise than by action of the Securities and Exchange Commission;

"(E) liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange;

"(3) The term 'Net Worth' shall be the excess of total assets over total liabilities, after provision for current dividends declared and unpaid by a member corporation (except that credit balances and equities in 'proprietary accounts' shall not be considered as liabilities) with securities, spot commodities, commodity future contracts in 'proprietary accounts' and all other assets marked to

market or fair value. A loss, at market, in an individual contractual commitment shall be deducted in determining Net Worth and a profit shall not be included. (See (c)(10) 'Special Provisions' below.)

"(4) the term 'Net Capital' shall be Net Worth, less the following:

Debit Items

"(A) Amounts included in Net Worth for:

"(i) Memberships, furniture and fixtures, real estate and other fixed assets;

"(ii) the value of securities which have no ready market or the sale of which is inhibited by a statutory, regulatory or contractual provision;

" . . . "

Rule 325.20

*"Subordinated borrowings by member organizations evidenced by non-transferable instruments.—*All subordinated borrowings by a member organization evidenced by instruments which are not transferable without the prior consent of the Exchange, where the proceeds, whether of cash or securities, or both, are to be considered in the computation of Net Capital under Rule 325, must receive prior approval of the Exchange. Such borrowings may be arranged with anyone acceptable to the Board of Governors and are subject to the following provisions:

"(1) Subordinated borrowings of cash

"(A) The lender may be paid interest not to exceed the rate set from time to time by the Exchange.

"(B) If the lender is

"(i) a member of the family of one of the borrowing organization's general partners or holders of voting stock, or of a deceased general partner or holder of voting stock;

“(ii) an estate of or trust established by or for one of the borrowing organization’s general partners or holders of voting stock;

“(iii) one of the borrowing organization’s employees or the employee pension, retirement or profit-sharing plan of the borrowing organization; or

“(iv) a limited partner or holder of non-voting stock of the borrowing organization

he may also share in organization profits to a reasonable extent.

“(2) Subordinated borrowings of securities

“(A) If the lender is a person listed in (1)(B) above, he may be paid interest not to exceed the rate set from time to time by the Exchange. He may also share in organization profits to a reasonable extent.

“(B) If the lender is anyone other than those listed in (1)(B) above

“(i) the number of such borrowings by a member organization shall be reasonable in relation to the size of the organization, and the total dollar amount of such borrowings shall not constitute more than 25% of the total capital of the borrowing organization.

“(ii) compensation for the loan or subordination of the account shall not exceed the rate set from time to time by the Exchange.

“(3) Application of the borrowing member organization shall be filed with the Exchange together with application signed by the lender, in form prescribed by the Exchange, which shall contain the following:

“(A) name of the lender; (identify the relationship of the lender to the organization or one of its general partners or holders of voting stock);

“(B) signed copy of the subordination agreement in form prescribed by the Exchange;

“(C) opinion of counsel to the borrowing organization stating that the subordination agreement is binding and enforceable in accordance with its terms upon the lender and his creditors;

“(D) check of the applying member organization for \$100 covering Exchange fee for consideration of the application. While the fee is payable at the time of posting, a member organization may request that the charge be placed on the regular quarterly statement from the Exchange;

“(5) Borrowings must be made pursuant to printed standard forms prescribed as permitted by the Exchange, to increase and in no event to decrease the permanence of the capital funds. These forms provide, among other things:

“(A) That cash may be contributed to a member organization by means of a cash subordinated loan agreement or a subordinated debenture, with a maturity date at least one year from the date of the subordinated loan or debenture, and with acceleration provisions, if any, which may be exercised on not less than six months' written notice given no sooner than six months from the date of the subordinated loan or debenture, provided that if, after giving effect to payment at maturity date or any accelerated maturity date, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital, or its Net Capital would fail to equal or exceed the minimum dollar amount required by Rule 325(a), the obligation of the member organization to repay the subordinated loan or debenture would be postponed until, after giving effect to such payment, the Aggregate Indebtedness of the member organization would not exceed 1200 per centum of its Net Capital or its

Net Capital would equal or exceed the minimum dollar amount required by Rule 325(a). The amount of a subordinated loan or debenture may be decreased or the principal may be paid off with the prior written approval of the Exchange. Each member organization shall promptly notify the Exchange of the receipt of any notice of accelerated maturity of any subordinated loan or debenture or if the payment of any subordinated debt is not made because, after giving effect to such payment, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to equal or exceed the minimum dollar amount required by Rule 325(a).

“(B) That securities which are fully paid for may be contributed to a member organization as collateral for a secured demand note, pursuant to a secured demand note collateral agreement which provides that if at any time the capital requirements value of the collateral is less than the then unpaid balance of the secured demand note the member organization shall notify the lender. Following such notification, the lender may (i) with the prior consent of the Exchange reduce the principal amount of the secured demand note by not more than 15%, provided the member organization clearly establishes that the Aggregate Indebtedness of the member organization would not exceed 1000% of its Net Capital after giving effect to such reduction, and further provided that in the event of such reduction the right of the lender to withdraw collateral shall be suspended, or (ii) contribute additional collateral sufficient to bring the value for Net Capital purposes of the collateral up to the then unpaid balance of the secured note. Unless the unpaid principal amount of the note is reduced or such additional collateral is so pledged, the collateral securing the note shall be sold on the business day next succeeding the giving of such notice. Without the prior written approval of the Exchange, the secured demand note may not be withdrawn prior to the withdrawal

date fixed in the collateral agreement, which date must be at least one year but not more than ten years from the date of the collateral agreement, provided, however, that the contributor may accelerate the withdrawal date by giving not less than six months written notice to the organization and to the Exchange delivered no sooner than six months from the date of the collateral agreement. At any time, if after giving effect to a proposed withdrawal, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to meet the minimum dollar amount required by Rule 325(a), the member organization's obligation to return the secured demand note and the collateral shall be suspended. Each member organization shall promptly notify the Exchange of the receipt of any notice of accelerated maturity of any secured demand note or if any withdrawal of subordinated debt is not made because, after giving effect to such withdrawal, the Aggregate Indebtedness of the member organization would exceed 1200 per centum of its Net Capital or its Net Capital would fail to meet the minimum dollar amount required by Rule 325(a).

“(C) That with the prior approval of the Exchange cash or securities (including equities in margin accounts) may be contributed to a member organization by its members, allied members, limited partners or holders of non-voting common stock as temporary capital for the purpose of adding to its Net Capital in connection with unusual underwritings. Such temporary infusions may not be made on more than three occasions in any twelve month period. If in the form of cash, the temporary subordinated loan would be evidenced by a temporary cash subordination agreement or a temporary subordinated debenture, and if in the form of securities by a secured demand note and a temporary secured demand note collateral agreement. The debenture or the collateral agreement shall bear a maturity date of 45 days from the

date thereof and may not be repaid at any time, if after giving effect to such repayment, the Aggregate Indebtedness of the member organization would exceed 1000 per centum of its Net Capital or its Net Capital should be less than the minimum dollar amount required by Rule 325(a). Neither agreement would contain any provisions for acceleration of the maturity date and a contributor pursuant to a temporary secured demand note collateral agreement would not have an option to reduce the principal amount of an undercollateralized note, but in almost every other respect, the temporary capital agreements would resemble the agreements described in A and B.

“(5) Each member organization which has subordinated debt or equity capital scheduled for withdrawal shall take whatever measures are necessary to replace the capital scheduled for withdrawal or to reduce its capital needs commensurate with the amount of capital remaining after withdrawal. Failure of the member organization to take such measures in a timely manner will result in corrective action being required by the Exchange under Rule 326.

“(6) A statement of a proposed lender for approval to make a subordinated loan to a member organization is ordinarily not acted upon by the Board of Governors until after notice of the proposal has been posted on the Bulletin Board of the Exchange for a period of two weeks. Such notice is posted upon submission, in proper form, of all required papers in connection with the proposal.”

Rule 325.30

“Disclosure of subordinated borrowings in financial statements to customers.—Subordinated liabilities of member organizations shall be disclosed in the body of condensed financial statements issued to customers and such disclosure shall not be made solely by means of footnotes to such statements.

"The subordinated liabilities may be shown in a separate section on the liability side of the statement following current liabilities and preceding net worth or capital or may be shown, for example, as follows:

"*Subordinated Liabilities and Capital:

Liabilities subordinated to claims of general creditors.....	\$
Capital (net worth or other acceptable title)	\$

"*If desired, this caption may be eliminated.

"If any subordinated liability is covered by an agreement which will expire within a short time and which will not be renewed, the time of expiration of such agreement should be clearly shown."

STATE OF NEW YORK)

: ss.:

AFFIDAVIT OF SERVICE

COUNTY OF NEW YORK)

JAMES B. KOBAK, JR., being duly sworn, deposes and says that he resides at 166 Millard Avenue, Montclair, New Jersey 07042; that on the 10th day of June, 1977, he served the within Joint Brief for Appellees on the attorneys for Appellants herein by mailing a true copy thereof, securely enclosed in a post-paid wrapper, in the mail box under the exclusive care and custody of the United States Postal Service at the corner of Wall Street and Broadway, New York, New York, addressed to said attorneys as follows:

Thomas P. Luning, Esq.
Schiff Hardin & Waite
7200 Sears Tower
233 South Wacker Drive
Chicago, Illinois 60606

Alan C. Winick, Esq.
500 Fifth Avenue
New York, New York 10036

Sidney Dickstein, Esq.
Dickstein, Shapiro & Morin
2101 L Street, N.W.
Washington, D.C. 20037

William J. Scott, Esq.
Attorney General of Illinois
160 North LaSalle Street
Chicago, Illinois 60601

Miller, Singer, Michaelson,
Brickfield & Raines
555 Madison Avenue
New York, New York 10017

Zalkin, Rodin & Goodman
750 Third Avenue
New York, New York 10017

Baer & Marks
70 Pine Street
New York, New York 10005

Stackpole & Amidon
P. O. Box 1016
Stowe, Vermont 05672

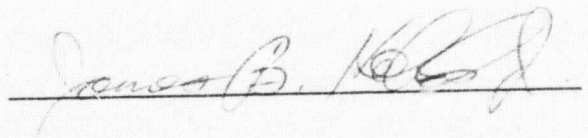
Arthur H. Kroll, Esq.
Patterson, Belknap, Webb & Tyler
30 Rockefeller Plaza
New York, New York 10020

Richard Tufaro, Esq.
Milbank, Tweed, Hadley & McCloy
1 Chase Manhattan Plaza
New York, New York 10005

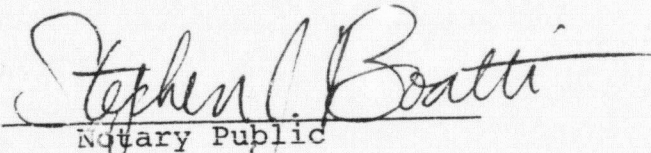
Office of General Counsel
Securities and Exchange Commission
Washington, D.C. 20549

The above addresses have appeared on the prior papers
in this action as the office addresses of said attorneys.

Deponent is over the age of 18 years and not a party
to this action.



Sworn to before me this
10th day of June, 1977.



Notary Public

STEPHEN J. BOATTI
Notary Public, State of New York
No. 4620033
Qualified in New York County
Commission Expires March 30, 1979

